



CENTRAL BANK OF CYPRUS
EUROSYSTEM

ANNUAL
REPORT
2009

NICOSIA - CYPRUS

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ABBREVIATIONS AND CONVENTIONS

ABBREVIATIONS

BSC	Banking Supervision Committee
CBC	Central Bank of Cyprus
CCBM	Collateral Central Bank Management
CDCR	Central Depository and Central Registry of the Cyprus Stock Exchange
CEBS	Committee of European Banking Supervisors
COLA	Cost of Living Allowance
CPI	Consumer Price Index
Cystat	Statistical Service of the Republic of Cyprus
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
ECP	Euro Commercial Paper
EMI	Electronic Money Institution
EMTN	Euro Medium Term Notes
EMU	European and Monetary Union
EONIA	Euro Overdraft Index Average
ERM II	Exchange Rate Mechanism II
EURIBOR	Euro Interbank Offered Rate
ESCB	European System of Central Banks
ESA 95	European System of Accounts 1995
EU	European Union
Eurostat	Statistical Office of the European Communities
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GRDS	Government Registered Development Stocks
HICP	Harmonised Index of Consumer Prices
IBU(s)	International Banking Unit(s)
IF(s)	Investment Fund(s)
IMF	International Monetary Fund
ISIN	International Securities Identification Number

LFS	Labour Force Survey
MFI(s)	Monetary Financial Institution(s)
MPC	Monetary Policy Committee
NACE	Nomenclature statistique des Activités économiques dans la Communauté Européenne (Statistical classification of the economic activities in the European Community)
NFCs	Non-Financial Corporations
NCB(s)	National Central Bank(s)
SBs	Savings Bonds
SCs	Savings Certificates
SDDS	Special Data Dissemination Standard
SDRs	Special Drawing Rights
SDW	Statistical Data Warehouse
SEPA	Single Euro Payments Area
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
TBs	Treasury Bills
T2S	TARGET2Securities

CONVENTIONS

CYP or £	Cyprus pound
€	euro
\$	US dollar
ST£	pound sterling

Thousands, millions and billions are separated by a dot (.) and decimals are separated by a comma (,). In some cases the totals in the tables may not add up due to rounding.

Note: The cut-off date for the statistics included in this report was 31 January 2010.

1. INTRODUCTION BY THE GOVERNOR

The year under review was difficult for the Cypriot economy, due mainly to external developments. The continued adverse economic conditions resulting from the global financial crisis, which peaked towards the end of 2008, forced governments and central banks around the world to continue their interventions in an effort to support their financial systems and their economies in general. Governments intervened through emergency expansionary fiscal measures, and central banks through reductions in key interest rates, liquidity enhancing operations and other non-conventional monetary policy measures. Even though financial conditions improved in early 2009, the impact of the crisis on real economies globally has been significant for the whole year under review.

The deterioration in domestic economic activity as a result of the adverse global conditions is reflected in the decline of real GDP during the year as well as by other economic indicators presented in this report. In particular, the growth rate of the Cyprus economy recorded a decline of 1,2% in the first nine months of 2009, and based on the flash estimate for the fourth quarter, real GDP for 2009 as a whole is expected to record a contraction of 1,5%. Moreover, during the year under review, unemployment increased significantly and HICP inflation experienced a major deceleration. It should be noted however that domestic inflationary pressures continue to persist. Even though core

inflation, namely HICP excluding energy and food prices, slowed down in 2009, it remained at levels higher than the average for the euro area thus further eroding the island's competitiveness.

Apart from the decline in economic activity and the rise in unemployment, a worrying development in 2009 was the significant deterioration in the budget deficit to 6% of GDP, which, based on a careful examination of the relevant data, can only partly be attributed to the decline in economic activity. Compared with the rest of the euro area countries the fiscal deficit is not excessively high, at first sight. About half of these countries have fiscal deficits higher than 6% of GDP. The difference, however, is that in most of these countries the economic downturn was deeper than in Cyprus. For this reason their fiscal balances have been affected more in 2009. In Cyprus the fiscal deterioration is mainly due to large increases in spending, especially in the last couple of years which was also a period of reduced government revenue. As a result, the budget deficit appears to be nearing a level that is not sustainable. Moreover, the fiscal situation is further aggravated by the prospects for the island's economy in 2010.

Despite the expected rebound of the international economy in 2010, the prospects for the Cypriot economy are not optimistic. The CBC's December 2009 forecasts project an anaemic growth of 0,3% for 2010.

Nevertheless, more recent data on several relevant indicators suggest that the domestic climate has deteriorated further since the time of the projections and that these estimates could prove to be optimistic.

Looking forward, the main aim should be the design of a well targeted and long-term fiscal policy in order to lay the foundations for the sustainable recovery of public finances, without hampering growth prospects and social and development policies. At the same time, fiscal consolidation will need to take into account the acute problem of financing the pension funds, a problem further exacerbated by the island's ageing population. This challenge must form a vital part of the long-term planning of fiscal policy.

A successful fiscal framework is also needed to safeguard the competitiveness of the Cypriot economy. Recent developments and prospects for inflation and wages vis-à-vis our trading partners, suggest that greater effort is needed on this front, especially structural measures and fiscal consolidation.

The fiscal policy challenges will have to be

tackled in a very difficult economic environment. Thus the establishment of a strategically designed and targeted long-term fiscal plan is of the utmost importance. Long discussed and urgently needed changes, such as reducing government spending, need to proceed without further delay. More generally, fiscal consolidation should be based primarily on reducing public expenditure, which, has followed an upward trend exceeding 45% of GDP, and increasing government revenue. The earlier the changes are implemented, the lower will be the cost to the economy from the inevitable corrective action. Although time is running out, there is still some room for adjustment of the fiscal and broader set of macroeconomic policies in order to avoid unpleasant developments that clearly lie ahead if no serious corrective measures are taken. If public finances deteriorate further, the measures necessary for fiscal consolidation will be immeasurably harder and more painful, and the credibility of our country will be further undermined.

Dr Athanasios Orphanides

Governor

2. MANAGEMENT AND ORGANISATION OF THE BANK

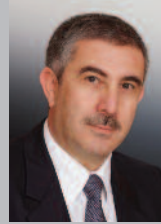
2.1 BOARD OF DIRECTORS



**Athanasios
Orphanides**



**Spyros
Araouzos**



**Marios
Klitou**



**Nicos
Constantinou**

Athanasios Orphanides

Governor and Chairman of the CBC from 2 May 2007.

Spyros Araouzos

Partner and director of a number of private companies. He has been the Honorary Consul General of Spain in Cyprus since 1968. He served as Chairman of the Board of the Cyprus Petroleum Refinery for five years, as a member of the Board of Cyprus Airways and as a member of the CBC's Board of Directors from 1979 to 1989. He was reappointed to the CBC Board in July 2004.

Marios Klitou

CEO of Baker Tilly Klitou and a Fellow of both the Institute of Chartered Accountants in England and Wales and the UK's Association of Chartered Certified Accountants. Also a member of the Institute of Certified Public

Accountants of Cyprus (ICPAC), Chairman of ICPAC's International Business, Shipping and Foreign Investments Committee and on the Board of the Cyprus Investment Promotion Agency. Served as a member of the President's Council of Economic Advisers and on the Board of Cyprus Development Bank Ltd. Appointed to the CBC Board in April 2008.

Nicos Constantinou

BSc in information systems and an MBA from the UK. He is a Fellow Member of the UK's Association of Chartered Certified Accountants (FCCA) and a Member of the Institute of Certified Public Accountants of Cyprus. Managing partner in an audit and consultancy practice and the International Franchise Director of an international retail business. He holds senior advisory positions in a number of international companies based in Europe and Asia. Appointed to the CBC Board in December 2008.



**Andreas
Matsis**



**Bambos
Papageorgiou**



**Haralambos
Akhniotis**

Andreas Matsis

Entrepreneur and Vice President of the Cyprus Chamber of Commerce and Industry. Served as President of the Famagusta Chamber of Commerce and Industry between 2002 and 2008. He also served on the CBC's Monetary Policy Committee between 2000 and 2007. Appointed to the CBC Board of Directors in December 2008.

Bambos Papageorgiou

Dr Papageorgiou received his PhD in political philosophy from University College London. In 1991 he joined the European University Cyprus Research Centre and today heads the Centre's Socio-Economic and Political Research Department. He previously served on the Board of the Cyprus Telecommunications Authority and has been a member of the CBC Board since December 2008.

Haralambos Akhniotis

He was first appointed to the CBC in 1963. Between 1992 and 2002 he was Chief Senior Manager of the Economic Research and Management Services Division and from 2002 to 2009 he served as Adviser to the Governor of the CBC. Between 2000 and 2007 he was a member of the CBC's Monetary Policy Committee and was also responsible for Cyprus's pre-accession negotiations for the chapter on Economic and Monetary Union. He also served as alternate to the Governor in the ECB's General and Governing Councils between 2004 and 2009. He was appointed to the CBC Board in May 2009.

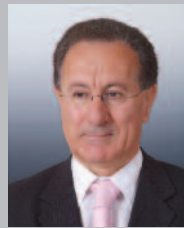
2.2 SENIOR MANAGEMENT TEAM



A. Orphanides
Governor



C. Poullis
Senior Director
Bank Supervision &
Regulation Department,
Bank Licensing Section,
and Human Resources,
Organisation & Methods
Department



K. Zingas
Senior Director
Financial Markets
Department,
Public Debt Management
Department, and
Payment Systems &
Accounting Services
Department



S. Michaelides
Senior Director
Security & Technical
Support Department,
and Publications
Section
(retires on 1 May 2010)



S. Stavrakis
Senior Director
Statistics Department,
and Financial Stability
Department



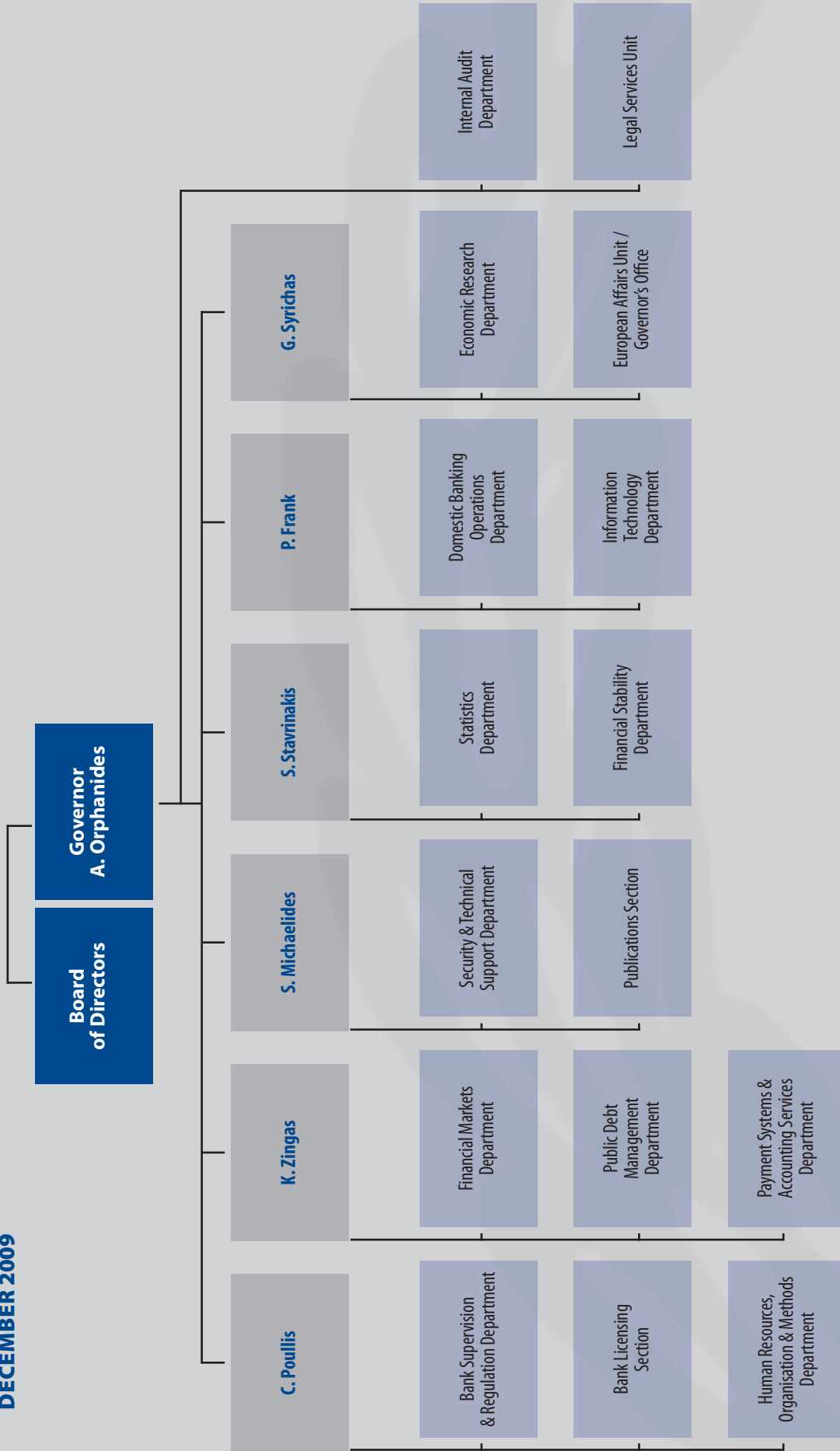
P. Frank
Senior Director
Domestic Banking
Operations
Department, and
Information
Technology
Department



G. Syrichas
Senior Director
Economic Research
Department, and
European Affairs Unit /
Governor's Office

2.3 ORGANISATIONAL CHART

DECEMBER 2009



3. Economic Developments

International economic developments

The year under review was crucial in assessing the effectiveness of the measures which were adopted globally in order to face the financial crisis which peaked in the autumn of 2008. The extensive use of both conventional and non-conventional monetary policy and the expansionary fiscal measures introduced in 2008, were largely successful in restoring investor confidence and normalising the financial environment in 2009. At the same time, there were major developments in the area of banking supervision at the international level. These are expected to play an important role in promoting the financial stability of the global economy. Notwithstanding the above, the financial crisis continued to have a major impact on global economic activity during 2009.

According to the latest data for the third quarter of 2009, the GDP of most economies recorded negative annual growth, with activity in the larger economies registering a small increase towards the end of the year. The latest estimates for 2009 point towards -4% GDP growth for the euro area, -2,5% for the US, -4,5% for the UK and -5,7 % for Japan (**Chart 3.1**).

Turning to prices, during 2009 they remained at low or even decreasing levels, mainly due to the base effect emanating from the oil prices in 2008. Specifically, in the third quarter of 2009 inflation stood at -0,1%, -0,2%, 1,5% and -2,5% in the euro area, the US, the UK and Japan, respectively (**Chart 3.2**).

CHART 3.1 GDP in selected countries
(annual change, %)

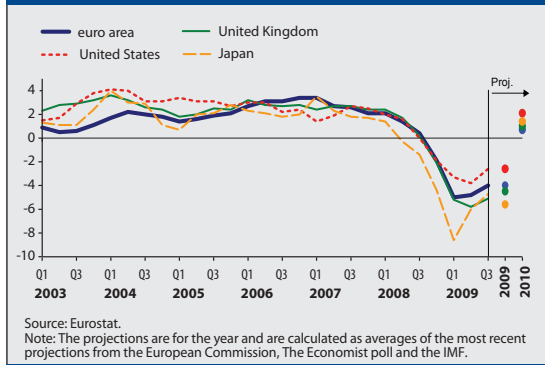
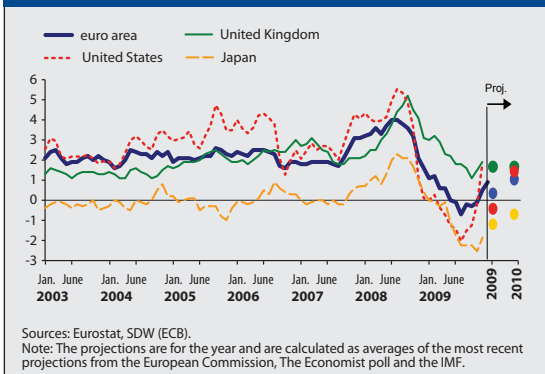


CHART 3.2 Inflation in selected countries
(annual change, %)



Amid low inflationary pressures, the major central banks continued with an expansionary monetary policy through reductions in their key interest rates and provision of liquidity against collateral, adopting, *inter alia*, non-conventional monetary policy measures. During the first months of 2009, both the ECB and the Bank of England proceeded with further interest rate cuts totalling 100 basis points, leading to historical lows of 1,00% and 0,50%, respectively, which were maintained until year end. The Federal Reserve adopted a wait and see stance throughout the year,

maintaining the federal funds rate at 0%-0,25%.

The first signs of improved economic sentiment in financial markets were reflected in the normalisation of interest rates in the interbank money market. Overall, the improved money market conditions, which were witnessed during the second quarter of 2009, improved further towards the end of the year. At the same time, following their peak at the end of the first quarter, the spreads of sovereign and corporate bonds against their benchmarks recorded a gradual decrease, highlighting improved confidence and positive investor expectations for an upturn in the global economy.

Promising signs were also reflected in global equity markets, following the increased demand for riskier assets. Following the first quarter of 2009, major stock markets rebounded from the very low levels experienced after the peak of the crisis in the autumn of 2008. Specifically, during 2009 the Dow Jones Eurostoxx index posted a 21,1% increase, the S&P 500 index soared by 23,4% and the Nikkei 225 index recorded an increase of 19%.

Towards the end of the year, the signs of

gradual recovery in the global economy were reinforced, with the most recent indicators supporting the view that the contraction in economic activity is coming to an end. However, the recovery process remains uneven and the outlook is still very uncertain. The upwardly revised projections by international institutions and analysts¹ for 2010 point towards GDP growth of 0,7% in the euro area, 2,1% in the US, 1% in the UK and 1,4% in Japan. Inflation is expected to reach 1% in the euro area, 1,4% in the US, 1,7% in the UK and -0,7% in Japan (**Charts 3.1 and 3.2, p 12**).

Domestic developments

Monetary developments^{2,3}

In 2009 the Cyprus economy was affected by the negative global economic environment and this was reflected in all indicators, including credit growth. Following strong growth during 2007 and the first half of 2008, credit expansion decelerated during 2009 in line with the general economic environment. Specifically, the annual rate of growth of credit to the private sector reached 8,4% in

1. Calculated as the mean of the most recent projections by: The Economist poll (03/12/2009), The European Commission (Economic Forecasts, Autumn 2009) and the IMF (World Economic Outlook, October 2009).

2. All monetary data, including interest rates, refer to data excluding the CBC and/or the Eurosystem. It should also be noted that all data analysed in this section refer to domestic residents of Cyprus and exclude organisations or corporations without a physical presence in Cyprus ("brass plate" companies). The "brass plate" companies are excluded in order to present domestic developments more clearly and achieve comparability of historical data.

3. In September 2009, there was an important change regarding the methodology for the calculation of annual percentage changes in monetary data, in accordance with the methodology used by the ECB. Monthly transactions are calculated from monthly differences in outstanding amounts adjusted for reclassifications, other recalculations and any other changes which do not arise from transactions, except for exchange rate adjustments. For details please refer to the CBC publication "Monetary and Financial Statistics", which is available on the CBC's website (www.centralbank.gov.cy).

Table 3.1 Loans to domestic households ^{(1), (2)}

	Outstanding balance as % of total ⁽³⁾		Annual percentage change	
	2009 Dec.	2008 Dec.	2009 Dec.	2008 Dec.
Domestic households	100,0	17,6	8,8	
1. Consumer credit	23,1	13,9	7,5	
2. Lending for house purchase	50,4	22,2	11,5	
3. Other lending	26,5	14,4	5,7	

Source: CBC.
(1) Sectoral classification is based on ESA 95.
(2) Including non-profit institutions serving households.
(3) As at the end of the last month available. Figures may not add up due to rounding.

December 2009 compared with 19,5% in the same month of the preceding year.

Credit to non-financial corporations (NFCs) grew by 9,3% in December 2009 compared with 22,7% in the same month of 2008. The slowdown had been continuous since September 2008, when credit growth reached 28,3%, which was the period of the peak of the crisis in the money markets.

Credit expansion to domestic households slowed to 8,8% in December 2009 compared with 17,6% in December 2008 (**Table 3.1**). The breakdown of credit by monetary and financial institutions (MFIs) and by purpose of loan shows that all three subcategories exhibited a slowdown, with housing loans recording the strongest deceleration. More specifically, these loans grew by 11,5% in December 2009 compared with 22,2% in the same month of 2008. Consumer credit grew by 7,5% compared with 13,9% in the previous year, while other lending increased by 5,7% during 2009 compared with 14,4% in 2008.

Table 3.2 Loans to domestic residents by economic activity of borrower: main categories

	Outstanding balance as % of total ⁽¹⁾	Annual percentage change	
		2008 Dec.	2009 Dec.
Manufacturing	3,6	18,7	4,4
Construction, real estate, renting and business activities	24,4	42,0	3,4
Wholesale and retail trade	8,8	26,4	1,1
Hotels and restaurants	4,6	4,1	4,2

Source: CBC.
(1) As at the end of the last month available.

In terms of the share of total loans to domestic households, housing loans continued in 2009 to account for the largest share with 50,4%. Consumer credit accounted for 23,1% while other lending represented 26,5% of new loans.

Turning to the breakdown of loans to domestic residents by economic activity of borrower, it is evident that all the main categories registered a deceleration in their growth rates (**Table 3.2**). In particular, loans to construction, real estate, renting and business activities grew by a mere 3,4% during 2009 compared with 42% in the preceding year, a slowdown which reflects the general course of the real estate sector. The aforementioned sectors accounted for 24,4% of total loans, hence the marked slowdown in credit growth appears to mainly reflect the noticeable deceleration in the wider property sector.

Credit growth to the wholesale and retail trade sector was also weak, amounting to

1,1% during 2009 compared with an increase of 26,4% in 2008.

The annual increase in loans to hotels and restaurants remained virtually unchanged at around 4%, with its share accounting for 4,6% of total loans. It should be noted that there had already been a deceleration in credit growth in this sector in December 2008.

Regarding the growth of private sector deposits⁴, this slowed down to 2,4% during 2009 compared with 7% in the previous year, mainly as a result of the marked deceleration in the growth of deposits from NFCs. The general trend of decreasing interest rates affected deposits negatively, which may have been used partly to repay loans. At the same time, the general economic uncertainty discouraged the taking up of new loans and, consequently, acted as a brake on a further increase in deposits.

Growth in deposits by domestic NFCs accelerated during the first three months of 2009, reaching an average of 12%, but as of April it entered into negative territory. The largest decrease was in September, amounting to 11%, while the downward trend continued until the end of the year, albeit at a lower rate, ending at -4,2%.

In contrast, the annual rate of growth of domestic household deposits (**Table 3.3**) remained close to the 2008 levels. More specifically, it reached 5,1% at the end of 2009

4. Excluding deposits from MFIs.

Table 3.3 Deposits from domestic households^{(1), (2)}

	Outstanding balance as % of total ⁽³⁾		Annual percentage change	
	2009 Dec.	2008 Dec.	2009 Dec.	2008 Dec.
Domestic households	100,0	5,6	5,1	
Overnight	15,5	-13,6	2,9	
With agreed maturity	73,8	22,0	7,4	
up to 2 years	69,9	24,5	8,6	
over 2 years	3,9	-3,6	-9,8	
Redeemable at notice	10,7	-31,2	-6,3	
up to 3 months	7,7	-34,7	-10	
over 3 months	3,0	-18,2	4,5	

Source: CBC.
(1) Sectoral classification is based on ESA 95.
(2) Including non-profit institutions serving households.
(3) As at the end of the last month available. Figures may not add up due to rounding.

compared with 5,6% in 2008. It is noted that deposits with agreed maturity grew by 7,4% in 2009 compared with an increase of 22% in 2008. Furthermore, deposits redeemable at notice decreased, as in the previous year, but at a slower rate. Specifically, these deposits decreased by 6,3% in 2009 compared with a fall of 31,2% in 2008. The above developments are in line with the trend observed since 2008 of a shift from short to long-term deposits with agreed maturity of up to two years. During 2009 the share of deposits with agreed maturity was 73,8% of total deposits while the share of deposits redeemable at notice amounted to 10,7%. The shift to long-term deposits is mainly due to continuous competition among MFIs in order to attract such deposits. In addition, the decrease in ECB policy rates, which affected interbank rates,

CHART 3.3 MFI interest rates on euro-denominated loans (new business) to euro area residents⁽¹⁾
(% per annum, period averages)

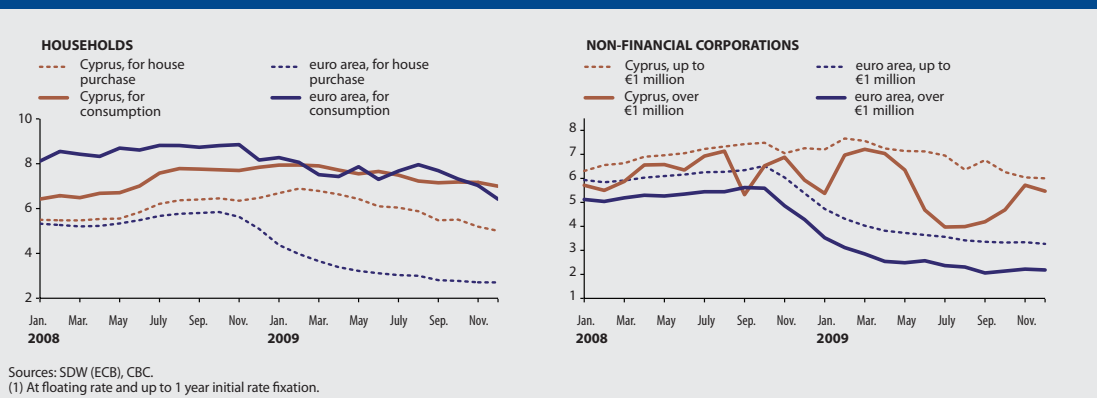
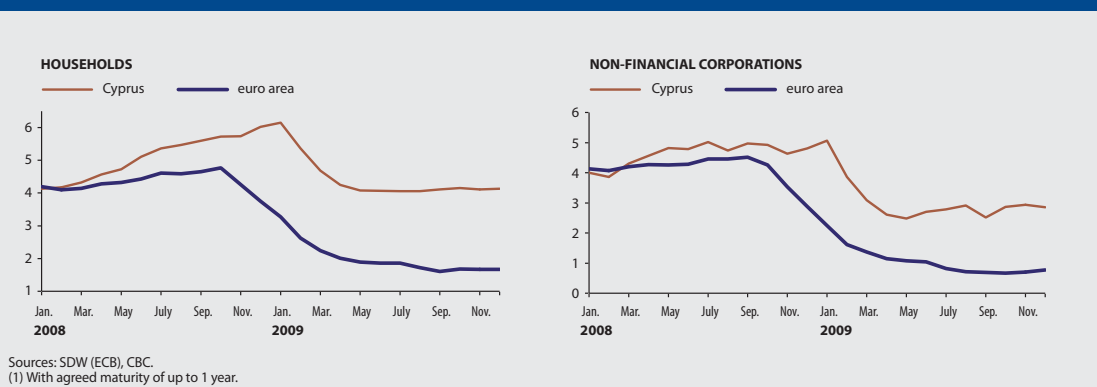


CHART 3.4 MFI interest rates on euro-denominated deposits (new business) to euro area residents⁽¹⁾
(% per annum, period averages)



had a negative impact on short-term deposit rates rendering them less attractive.

Interest rates

Interest rates on new loans to and on new deposits from NFCs and households, in both the euro area and Cyprus, recorded a decrease in 2009 (**Charts 3.3** and **3.4**). This is mainly attributable to the expansionary monetary policy of the ECB and the gradual stabilisation of the monetary policy transmission mechanism in the markets, following the peak of the financial crisis in the third quarter of 2008.

Nevertheless, during 2009 the reduction observed in domestic average interest rates (on loans and deposits) was lower compared with that for the respective euro area rates. This can be partly attributed to the intense competition between the cooperative sector and the commercial banks in their attempt to attract new deposits, thus restricting the reduction in borrowing costs. In addition, the lack of available assets, such as special government bonds, which could have been used by the MFIs as collateral in order to obtain cheap liquidity through the

open market operations of the Eurosystem, also helped to preserve the interest rate differential between the euro area and Cyprus. Finally, the domestic climate in which the legal framework governing decisions on supervisory matters was questioned had an adverse effect on the flow of foreign deposits to Cyprus and, consequently, prevented the further reduction in domestic interest rates.

As far as interest rates on loans are concerned, the average rate on new loans of up to €1 million⁵ to NFCs in Cyprus was reduced from 7,20% in January 2009 to 6,00% by the end of the year. The respective average rate in the euro area fluctuated at lower levels, and ended the year at 3,27% compared with 4,73% in January 2009. The average rate in Cyprus on new loans of over €1 million⁶ to NFCs reached 5,47% in December, while the corresponding average rate in the euro area reached 2,18% in the same month.

The average interest rate for new housing loans to households⁷ in Cyprus declined to 5,00% at the end of the year, from 6,69% in January 2009. The corresponding average rate in the euro area also declined during 2009 and stood at 2,71% at end-year, thus maintaining the difference between the two rates at 230 basis points. At the same time, the average interest rate for new loans to Cypriot households for consumption⁸

decreased slightly from 7,94% in January 2009 to 7,00% in December. In the euro area, there was a larger decrease in the corresponding average rate during the year. As a result, even though at the beginning of the year the rate in the euro area was higher than in Cyprus, by the end of the year it was lower by 58 basis points.

It should be noted that preliminary data for January 2010 point towards further reductions in interest rates on new loans, both to NFCs and households.

Deposit rates followed a similar downward trend (**Chart 3.4**, p.16). In particular, the average rate on new deposits with an agreed maturity of up to one year from NFCs decreased from 5,07% in January 2009 to 2,86% at the end of the year, while the respective euro area rate decreased from 2,24% to just 0,77%. A reduction was also recorded in the average rate on new deposits from households with an agreed maturity of up to one year. More specifically, the rate in Cyprus declined from 6,15% in January 2009 to 4,13% by the end of 2009, with the corresponding rate in the euro area declining from 3,28% to 1,67%, respectively.

Inflation

In line with the global economic environment, the national CPI inflation rate registered a significant deceleration of 0,3% in 2009

5, 6, 7, 8. For the category of floating rate and up to 1 year initial rate fixation.

compared with an increase of 4,7% in 2008. The HICP also registered a deceleration of 0,2% in 2009 compared with 4,4% in 2008.

More analytically, the significant slowdown observed in the HICP during the year under review, was mainly driven by the marked reduction in global oil prices as well as the appreciation of the euro against the dollar. As a result, a significant decrease was recorded in the prices of domestic fuel and electricity. In aggregation, the category of energy prices registered a fall of 15,7% in 2009 compared with a rise of 13,9% in 2008.

Furthermore, reductions in the prices of fruit and vegetables, which began in the summer of 2009 onwards, also contributed to the overall deceleration in total HICP. In particular, the prices of vegetables registered an average decrease of 2,3% in 2009, compared with an increase of 10,5% in 2008. At the same time, the average prices of fruit decelerated by 3% in 2009 compared with a rise of 15,4% in 2008. As a result, unprocessed food prices decelerated by 4,2% in 2009 compared with a rise of 7,4% in 2008.

Regarding processed food prices, an increase of 3,7% was recorded during the year, remaining unchanged from 2008. However, this category registered a significant deceleration of 1,2% in the fourth quarter of 2009 compared with an acceleration of 5,8% in the first quarter of 2009 and a rise of 4,7% in the fourth quarter of 2008, mainly due to the slowdown in the prices of milk and bread.

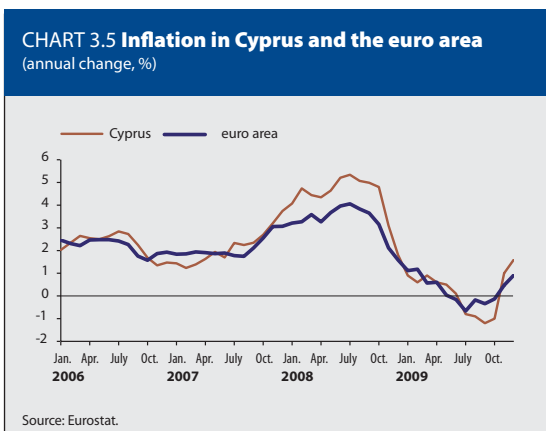
The growth rate of prices of industrial goods

excluding energy touched negative territory in 2009. More specifically, prices decreased by 0,2% in 2009 compared with a slight increase of 0,1% in 2008. This was mainly due to bigger summer sales in clothing and footwear compared with 2008 as well as significant further reductions in the prices of motor vehicles registered at the beginning of the year under review.

Regarding the prices of services, an increase of 3,4% was recorded during 2009 compared with 4,4% in 2008. More specifically, despite the decrease in prices of accommodation services, which on average reached 8% in 2009 reflecting the policy to revitalise the tourism sector, there were significant increases in the prices of medical services and restaurants of 11,4% and 5,6%, respectively.

It is also noted that the HICP inflation differential between Cyprus and the euro area was reversed in July 2009, with domestic inflation being lower than that in the euro area. More specifically, during 2009 domestic inflation was lower by ten basis points compared with the euro area HICP, in contrast with 2008 during which domestic inflation was higher by 110 basis points. The significant reduction in the price of oil was the main reason for the reversal of the trend, since movements in the oil price have a larger effect on energy prices in Cyprus compared with the euro area (**Chart 3.5**, p.19).

Core inflation, that is HICP excluding the prices of energy and food, registered a deceleration of 1,7% in 2009 compared with



2,5% in 2008. However, it remained higher than the corresponding euro area figure which reached 1,3% in 2009.

Demand

Based on available preliminary data for the first nine months of 2009, real GDP contracted by 1,2% compared with a 4% increase recorded in the corresponding period of 2008. The flash estimate for the fourth quarter of 2009 indicates that the contraction of real GDP for the whole of 2009 reached 1,5%.

More specifically, during the first nine months of 2009 public consumption recorded a small increase of 0,1% compared with a 10,2% increase in the corresponding period of 2008, mainly reflecting the decrease in the government's operating surplus and in the income from sales of goods and services. Private consumption also experienced a considerable slowdown during the period under review, increasing by a mere 0,8% compared with a 10,4% increase in the corresponding period of 2008. In contrast, imports

of goods and services decreased by 20,1% compared with a 13,4% increase recorded in the corresponding period of 2008. The positive growth rate of private consumption in conjunction with the significant decrease in imports, reflects the significant decrease in stocks of €160,9 million during the first nine months of 2009. Capital investment also experienced a decrease of 7,2% compared with an increase of 11,9% recorded during the corresponding period of 2008. The global financial crisis also affected significantly domestic exports, which recorded a decrease of 11,3% compared with the 1,5% decrease in the corresponding period of 2008.

Production

Major sectors of the economy such as construction, wholesale and retail trade, hotels and restaurants, transport, storage and communication contracted during the first nine months of 2009, due to the negative effects of the international crisis (**Table 3.4**, p.20). Although financial intermediation decelerated, the sector still recorded positive growth.

More analytically, economic activity in the construction industry decreased by 4,7% in the first nine months compared with a 6,6% increase in the corresponding period of 2008, while a similar trend was recorded in the real estate sector. Various economic indicators in the fourth quarter of 2009 point to a further slowdown in sales of real estate and a further contraction in the construction sector. For

Table 3.4 Economic activity in basic sectors, at 2005 market prices
(chain linking method, annual percentage change)

	Construction	Wholesale and retail trade, hotels and restaurants, transport, storage and communication	Financial intermediation and other services
Q1 2007	5,7	9,2	8,1
Q2 2007	7,4	6,5	7,5
Q3 2007	8,9	5,4	6,9
Q4 2007	8,5	5,9	6,7
Q1 2008	10,1	4,0	4,6
Q2 2008	6,0	3,9	4,1
Q3 2008	4,0	1,4	4,3
Q4 2008	-1,0	1,2	5,1
Q1 2009	-2,8	-3,6	5,8
Q2 2009	-4,9	-6,2	3,1
Q3 2009	-6,3	-7,4	1,0

Source: Cystat.

example, data from the Department of Lands and Surveys show that the number of title deeds decreased by 38,4% in 2009 compared with a decline of 34,6% in 2008. Also, the number of sales contracts, which is considered to be a better indicator of the net sales of property, recorded a decrease of 44% in 2009 compared with a 34% decrease in 2008.

Balance of payments

The current account deficit in 2009 is expected to record a significant improvement after the historically large deficit of 2008, when it reached 17,7% of GDP. The improvement in 2009 is attributed to the reduced imports of goods as a result of weak domestic demand and the decrease in oil prices. Despite the projected improvement, the deficit is expected to remain relatively high, in line with negative external demand during 2009, which influenced important sectors of the economy, such as tourism and

transport. As far as the financing of the current account deficit is concerned, in 2009 there was a rise in short-term financing in line with the trend observed during the last few years.

Current account balance

Based on provisional data, the current account deficit reached €592,4 million or 4,7% of GDP in the first nine months of 2009, compared with a deficit of €1.801,9 million or 14% of GDP in the corresponding period of 2008. The developments in the current account were mainly the result of the improvement in the trade account and, to a lesser extent, the improvement in the income account.

The improvement of the trade account was mainly the result of weak domestic demand and lower oil prices. Specifically, large decreases were observed in the imports of oil, transport equipment and intermediate goods. The decline in the trade account reached

24,9%, in the period under review. Exports of goods registered similar decreases mainly due to the decrease in re-exports and, to a lesser extent, the decrease in exports of domestically produced exports. This decrease did not significantly influence the trade account as the value of exported goods was much lower than the value of imported goods.

The surplus in the services account – which has historically played an important role in reducing the current account deficit – was down by €166 million in the first nine months of 2009, compared with the corresponding period of 2008. This was mainly the result of the decrease in tourism revenues and, to a lesser extent, the decrease in transport revenues, which outweighed the increase in income from financial services. A significant improvement of €357 million was observed in the income account in the first nine months of 2009, compared with the corresponding period of 2008. Finally, current transfers deteriorated slightly in the period under review.

Based on available data for the first nine months of 2009 and some additional information from the last quarter of the year, the CBC's projections for the whole year point to a significant improvement of the current account deficit to about 8,5% compared with 17,7% of GDP in 2008.

Capital and financial account

Prior to 2007, the current account deficit in

Cyprus was financed mainly by foreign direct investment (FDI). Since 2007, when the current account deficit reached much higher levels, the category of 'other investment', which is regarded as a shorter-term financing tool, has increased. Up to and including 2006, the share of FDI in the current account deficit was above 50%, while during the period 2007 – 2008 it was below 50%. This share is expected to remain at relatively low levels in 2009.

The financial account showed a surplus of €586 million in the first nine months of 2009 compared with a surplus of €1.792,1 million in the corresponding period of 2008. The decrease in the surplus was a result of the significant increase of €1.663,3 million in 'other investment' compared with the corresponding period of 2008. All the other categories showed an increase. Specifically, direct investment increased by €255 million, financial derivatives by €117,1 million and portfolio investment by €190,5 million, compared with the corresponding period in 2008 (**Table 3.5**, p.22).

Exchange rates

In 2009 the euro appreciated by 11,9% against sterling, while it recorded a depreciation of 5,2% and 14,5% against the dollar and the yen, respectively (**Chart 3.6**, p. 23).

As far as the real effective exchange rate of Cyprus is concerned, it recorded an appreciation of 1,1% in 2009 compared with 2008, mainly because of the significant appreciation of the euro against sterling (**Chart 3.7**, p. 23).

Table 3.5 Balance of payments
(€ million)

	2008 (Jan. - Sep.)			2009 (Jan. - Sep.)		
	Credit	Debit	Net	Credit	Debit	Net
CURRENT ACCOUNT	7.973,8	9.775,7	-1.801,9	7.246,0	7.838,4	-592,4
GOODS, SERVICES AND INCOME	7.515,5	9.286,5	-1.771,0	6.908,5	7.380,3	-471,9
GOODS AND SERVICES	5.818,2	7.386,6	-1.568,4	5.099,6	5.725,9	-626,3
GOODS	877,5	5.116,4	-4.238,8	726,1	3.856,8	-3.130,7
SERVICES	4.940,6	2.270,3	2.670,3	4.373,5	1.869,1	2.504,4
Transport	1.354,6	862,4	492,2	1.092,1	685,5	406,6
Travel	1.531,1	811,0	720,1	1.278,1	718,0	560,0
Communications services	63,9	84,6	-20,7	49,5	54,9	-5,4
Construction services	86,0	10,0	76,0	32,2	7,7	24,5
Insurance services	101,5	36,5	65,1	59,8	30,4	29,5
Financial services	512,7	127,0	385,7	634,2	103,3	530,9
Computer and information services	102,9	14,7	88,2	50,3	11,5	38,8
Royalties and licence fees	7,1	14,8	-7,7	7,0	16,1	-9,0
Other business services	1.022,9	205,9	817,0	1.052,1	177,1	875,0
Personal, cultural and recreational services	28,8	41,4	-12,6	18,3	22,4	-4,1
Government services, n.i.e.	129,0	61,9	67,1	99,9	42,3	57,6
Services not allocated	0,0	0,0	0,0	0,0	0,0	0,0
INCOME	1.697,3	1.899,9	-202,6	1.808,8	1.654,4	154,4
Compensation of employees	44,3	230,8	-161,3	41,2	133,0	-73,6
Investment income	1.653,0	1.669,1	-16,2	1.767,7	1.521,4	246,3
Direct investment income	159,1	579,2	-420,1	299,5	516,5	-217,0
Portfolio investment income	634,6	498,6	136,0	647,8	424,1	223,7
Other investment income	859,3	591,4	267,9	820,4	580,7	239,7
CURRENT TRANSFERS	458,4	489,2	-30,8	337,6	458,0	-120,5
General government	94,9	142,0	-47,1	92,7	145,2	-52,4
Other sectors	363,5	347,2	16,3	244,8	312,9	-68,0
CAPITAL AND FINANCIAL ACCOUNT			1.792,1			222,1
Capital account	47,1	33,7	13,4	50,3	28,6	21,7
Financial account			1.778,7			564,3
Direct investment			-12,7			119,3
Abroad			-714,0			-45,2
In Cyprus			701,3			608,4
Portfolio investment			-5.021,8			-4.292,7
Assets			-6.231,6			-3.886,5
Liabilities			1.209,8			-775,5
Financial derivatives			-106,3			-4.452,7
Other investment			6.746,8			8.225,1
Assets			-3.671,3			-6.920,2
Liabilities			10.418,0			12.086,5
Official reserve assets			172,8			-179,2
Net errors and omissions			9,8			10,3

Source: CBC.

Labour market, productivity and labour costs

The effects of the financial crisis on the economy of Cyprus were also reflected in the labour market. In particular, employment

recorded a decrease of 0,6% in the first nine months of 2009 compared with an increase of 3,1% in the respective period of 2008, and a 2,8% increase for the whole of 2008. The corresponding annual decrease for 2009 is

CHART 3.6 Selected exchange rates against the euro
(index of monthly average rates, 2000 = 100)

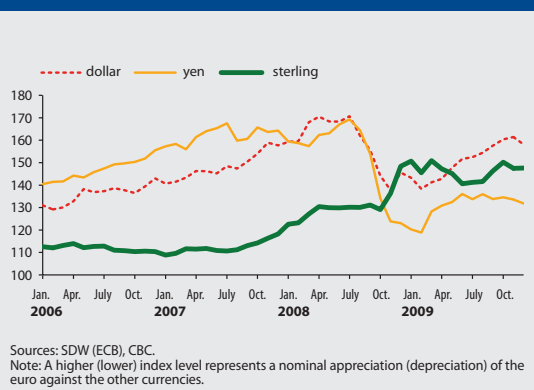
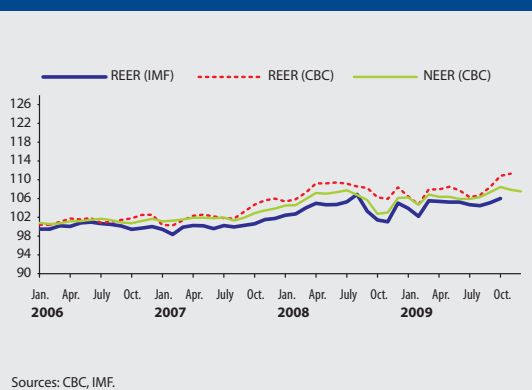


CHART 3.7 Real and nominal effective exchange rates of the Cyprus currency (IMF weights)
(Base year 2000=100)

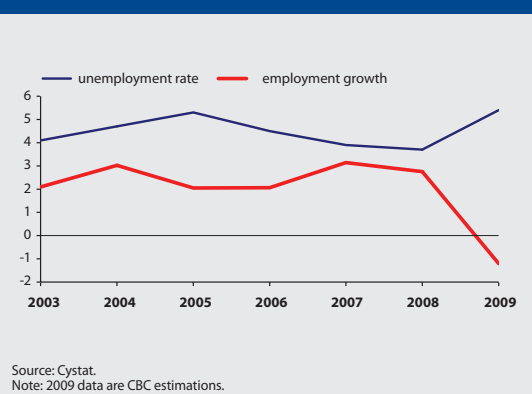


expected to be around 1,1%⁹. As far as unemployment is concerned, the unemployment rate, which is based on the Labour Force Survey (LFS), stood at 5,1% in the first nine months of 2009 compared with 3,8% in the respective period of 2008 (**Chart 3.8**).

The registered unemployment rate for the whole of 2009 reached 4,3% compared with 2,9% in 2009, while the number of registered unemployed increased by 51,7% in 2009. It is worth noting that the number of registered unemployed, and therefore the rate of registered unemployment, are lower than the respective figures recorded by the LFS because of differences in the methodologies of the two unemployment measures¹⁰.

The productivity of the Cyprus economy recorded a reduction of 0,5% in the first nine

CHART 3.8 Employment growth and unemployment rate

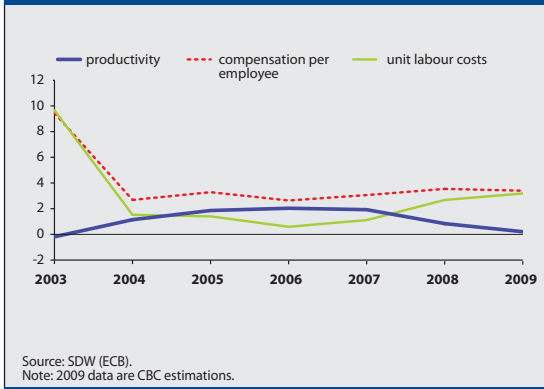


months of 2009 compared with an increase of 0,9% in the respective period of 2008, and a 0,8% increase for the whole of 2008. The decline for the whole of 2009 is expected to reach 0,2%. This, combined with the projected decrease of employment by 1,1%, contributed to the contraction of real GDP in 2009.

9. The quarterly data on employment refer to physical persons while the annual data refer to full-time equivalent persons.

10. Newcomers in the labour market and persons who are unemployed for more than six months do not have a financial incentive to register as unemployed, even though they are considered as unemployed using the international definition of unemployment and, therefore, by the LFS as well. On the other hand, retirees from the public sector register as unemployed even though they do not fall under the international definition of unemployment. These are fewer in number than the unemployed from the two aforementioned categories.

CHART 3.9 Compensation per employee, productivity and unit labour costs
(annual change, %)



As far as labour costs are concerned, compensation per employee increased by 4% during the first nine months of 2009 compared with a 4,5% increase in the corresponding period of 2008. Unit labour costs, which were largely affected by the decrease in productivity, and despite the slight deceleration of compensation per employee, rose by 4,5% in the first nine months of 2009 compared with an increase of 3,5% in the respective period of 2008 (**Chart 3.9**).

Public finances¹¹

In 2008 a budgetary surplus of 0,9% of GDP was recorded, which is expected to reverse into a large deficit in 2009. Despite the fact that the Ministry of Finance was, until October, anticipating that the deficit would be below 3% of GDP, the latest official forecasts suggest that the deficit will rise to around 6% of GDP. The fiscal deterioration is

not only due to the economic slowdown in Cyprus but also to significant increases in public spending and large reductions in tax revenues across several categories. The public debt to GDP ratio recorded a significant fall, reaching 48,4% in 2008, partly due to the reduction in sinking funds, and is expected to rise significantly to 55,2% of GDP in 2009. The projected deficit in the primary balance and the projected decline in nominal GDP are the main causes of the increase in public debt.

According to provisional data on general government finances compiled by Cystat during the first nine months of 2009, a 2,7% budget deficit was recorded compared with a surplus of 2,8% for the same period of 2008. Additionally, in the first nine months of 2009 the primary deficit reached 0,8% of GDP, in contrast to the first nine months of 2008 when a surplus of 5,1% of GDP was recorded. The total expenditure of general government increased by 9,4% in the first nine months of 2009, compared with the corresponding period in 2008, while total revenues decreased by 8,4% (**Table 3.6**, p.25).

Specifically, a significant decline of 12,6% in revenues in the 'Current taxes on income, wealth, etc' category was recorded in the first nine months of 2009, compared with the corresponding period in 2008. This sharp decrease is mainly attributable to the slowdown in real estate market transactions. This is confirmed by

11. The analysis in this section is based on data for the first nine months of 2009 as public finance statistics for the whole of 2009 were not available up until the cut-off date for data in this report.

Table 3.6 Accounts of general government
(€ million)

	Jan.-Sep. 2008	Jan.-Sep. 2009	Change
EXPENDITURE			
Intermediate consumption	555,8	648,3	92,5
Capital formation	285,7	392,7	107,0
Compensation of employees	1.707,5	1.836,2	128,7
Other taxes on production	0,4	0,1	-0,3
Subsidies	1,4	1,2	-0,2
Interest paid	398,9	321,8	-77,1
Social transfers	1.511,2	1.645,9	134,7
Other current transfers	567,2	612,4	45,2
Capital transfers	15,0	56,4	41,4
Total expenditure	5.043,1	5.515,0	471,9
REVENUE			
Market output and output for own final use	346,6	303,8	-42,8
Taxes on production and imports	2.404,7	2.007,7	-397,0
<i>of which VAT</i>	1.443,3	1.289,6	-153,7
Property income	112,8	143,7	30,9
Current taxes on income, wealth, etc	1.554,8	1.359,3	-195,5
Social contributions	1.024,7	1.144,6	119,9
Other current transfers	80,0	95,0	15,0
Capital transfers	3,0	6,3	3,3
Total revenue	5.526,6	5.060,4	-466,2
Surplus (+) / Deficit (-)	483,5	-454,6	-
Surplus (+) / Deficit (-) % of GDP	2,8	-2,7	-

Source: Cystat.

the Inland Revenue Department figures, which report a large decline in revenue from capital gains tax of the order of 77% for the period January-November 2009 compared with the corresponding period in 2008. Total receipts by the Inland Revenue Department for the first 11 months of 2009 decreased by 15%. Additionally, revenues recorded under the 'Taxes on production and imports' category decreased by 16,5% in the first nine months of 2009, attributed to the slowdown in the construction and real estate sector as well as the decrease of 10,6% in VAT receipts due to the recession in Cyprus. The decline in total general government revenue would have been even greater had social security contributions not increased.

The latter was due to the implementation of the first stage of the increase in social security contributions, which was adopted by the Government in 2009 as part of the measures intended to promote the long-run sustainability of public finances.

As regards general government expenditure, during the first nine months of 2009 significant increases of 7,5% and 8,9% were registered in the compensation of employees and social payments, respectively. The increases in these categories, which are the two largest categories of expenditure, are widely considered as not being easily reversible. A large increase was also recorded in spending on capital goods, as a result of the increased utili-

Table 3.7 Central Bank of Cyprus projections
(annual change, %)

	2008	2009f	2010f	2011f
HICP				
December Projections 2009	4,4	0,2	2,6	2,3
June Projections 2009	4,4	1,0	3,0	-
GDP				
December Projections 2009	3,6	-1,3	0,3	1,8
June Projections 2009	3,7	0,4	0,7	-

Sources: Cystat, CBC.

sation of the government development budget in response to the economic crisis.

Finally, it should be stressed that if the fiscal deterioration is not dealt with in a timely and determined manner with the appropriate policies, then the measures imposed on us by the European Commission as part of the excessive deficit procedure, which we will be entering soon, are likely to be more painful.

Forecasts

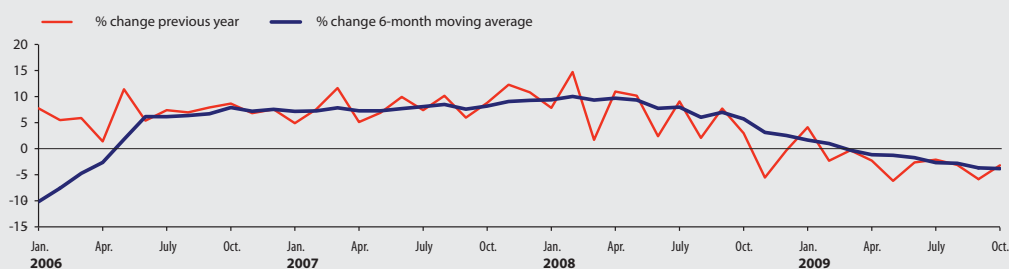
According to the CBC's projections, which are based on the working assumptions of the Eurosystem and are published in the December 2009 issue of the *Economic Bulletin*, HICP inflation was projected to reach 0,2% due to low oil prices and the effects of the global financial recession. In 2010 HICP inflation was expected to reach 2,6% due to the base effect of the low oil prices recorded during 2009 and the anticipated increase in the prices of unprocessed food. In 2011 HICP inflation was projected to reach 2,3% mainly reflecting the expected deceleration in the

increase of energy prices. As far as the national accounts are concerned, real GDP growth was expected to decrease by 1,3% in 2009 and to register an increase of 0,3% in 2010 and 1,8% in 2011 (**Table 3.7**). The projections for GDP reflect the negative international developments, the decrease in domestic demand, as indicated by among other things the downward trend in retail sales and credit card spending (**Charts 3.10** and **3.11**, p.27), and the contraction of the construction sector.

Taking into account developments in the domestic economy since December 2009, the current projections are considered particularly uncertain and possibly optimistic. The risk for a further weakening of the economy with an even greater negative impact on domestic demand is considered at this point to be more likely.

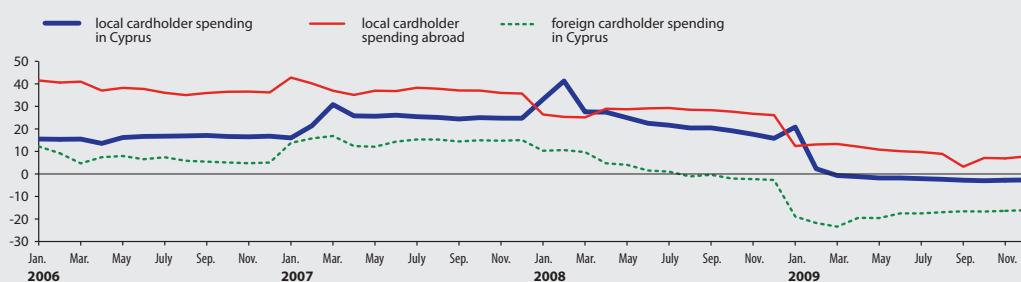
The risks for GDP growth stem mainly from the uncertainty regarding the duration and the impact of the domestic recession. Risks also arise from the uncertainty regarding the future path of domestic demand, credit conditions, investments, the tourist and construction sectors, and the unemployment rate. In addition, the excessive deficit procedure that is expected to be implemented for Cyprus will likely have a negative impact on public and private consumption, investment and, consequently, on GDP growth. On the other hand, the possibility of a swifter global recovery may

CHART 3.10 Retail sales



Source: Cystat.

CHART 3.11 Credit card spending
(cumulative annual % change from January)



Source: JCC Payments System Ltd.

have positive consequences for GDP growth mainly through increased exports of services.

The risks to HICP and HICP excluding energy for 2010 and 2011 stem mainly from a possible lengthier and deeper impact of the domestic downturn than was originally assumed. This will have a negative impact on the prices of services and industrial goods excluding energy.

In addition, the possibility of a further increase in unemployment and a decrease in wages may further dampen the inflation rate. In contrast, larger increases in the price of oil,

agricultural products and services create inflationary pressures, which may be further fuelled by an increase in credit expansion.

Despite the expected rebound of the international economy in 2010, the prospects for the Cypriot economy are not optimistic. The CBC's December 2009 forecasts project an anaemic growth of 0,3% for 2010. Nevertheless, more recent data on several relevant indicators suggest that the domestic climate has deteriorated further since the time of the projections and that these estimates could prove to be optimistic.

4. Functions of the Bank

4.1 Regulation and Supervision of the Banking Sector

Supervision of banking institutions

Under the *Central Bank of Cyprus Law, 2002-2007* and the *Banking Law, 1997-2009*, the CBC is the competent authority for the licensing and supervision of banks. In light of the uncertainty currently faced by the global economy, the CBC's supervisory role is of particular importance. Banks now operate in an uncertain environment with intense competition, their efforts focused on increasing market share. Hence, the supervision exercised by the CBC aims at ensuring that the risks assumed by banks are contained within acceptable limits. The CBC's main objective is the maintenance of the stability of the banking sector and the minimisation of systemic risk, so as to ensure public confidence in the banking system and to protect the interests of depositors.

In exercising its supervisory role, the CBC is guided by the recommendations of the Basel Committee on Banking Supervision, the guidelines issued by the Committee of European Banking Supervisors (CEBS) and the rules of the EU which promote the adoption of best practices and standards. In this connection, various directives and guidelines regarding prudential supervision are issued by the CBC to all banks operating in Cyprus.

The supervision of banks incorporated in Cyprus, including both their domestic and foreign subsidiaries and branches, is exercised by the CBC on a consolidated basis. The

subsidiaries and branches of foreign banks which are established in Cyprus are also subject to supervision by the CBC. There are currently 43 banks operating on the island. Seventeen of these are incorporated in Cyprus (nine are subsidiaries of foreign banks), while 26 are branches of foreign banks (nine are branches of banks incorporated in EU countries and 17 are branches of banks incorporated in third countries). There are also two representative offices of foreign banks.

During the year under review, a branch of a bank established in another EU member state, which had exercised its right of establishment under the *Banking Law*, terminated its operations in Cyprus. Also, 21 banks established in other EU member states exercised their right for the free provision of services on the island without a physical presence, under the said law. As a result, the total number of banks established in other EU member states that have the right to offer services in Cyprus without a physical presence reached 216.

The supervision of banks is exercised by applying two methods that complement each other: (a) off-site monitoring of banks' compliance with CBC directives and circulars through the analysis of various periodic prudential returns submitted to the CBC, covering an extensive range of banking operations; and (b) on-site examinations, which aim at evaluating the financial condition of banks and assessing the level of risks that they undertake. More specifically, on-site examinations focus on areas such as

the quality of management, organisational structure, internal audit, risk management (credit, interest rate, foreign exchange, etc.), profitability/yield, adequacy of provisions for doubtful debts and compliance with CBC directives and circulars. The CBC plans and conducts on-site examinations in such a way as to supervise the most significant risks (risk based bank examination). In this context, the CBC reviews all the operations of banks, identifies the inherent risks and assesses the materiality of the risks associated with each operation by applying its own Risk Assessment System. Moreover, the CBC evaluates the level of transparency and banks' compliance with the rules of corporate governance set out in its Framework of Principles of Operation and Criteria of Assessment of Banks' Organisational Structure, Internal Governance and Internal Control Systems Directive. The frequency and intensity of the examinations are governed by the principle of proportionality, i.e. according to the size, nature, systemic importance, scale and complexity of a bank's activities.

Developments in the banking supervisory framework

In exercising its supervisory powers, the CBC places great emphasis on the timely adoption of the EU regulatory framework, the guidelines issued by the CEBS and the core principles for effective banking supervision issued by the Basel Committee on Banking Supervision. In this respect, the CBC prepares legislative proposals

and publishes, from time to time, various directives, guidelines and circulars to banks.

- *Amendment to the Banking Law*

In August 2009, the House of Representatives enacted an amendment to the *Banking Law, 1997-2008*, by which the provisions of EU Directive 2007/44/EC relating to the mergers and acquisitions of banks, were transposed into national legislation. Also, the maximum permissible limits of investments by banks in the share capital of any company, other than banks, were increased in line with the provisions of EU Directive 2006/48/EC. Amendments were made to the provisions of the law, which will come into effect in July 2010, with respect to the submission of information to the CBC by banks on the beneficial owners who hold at least 5% of a bank's share capital, and the reduction in the maximum permissible limits of exposures to a director / all directors of a bank.

Following the above amendment, the CBC prepared the *Unofficial Consolidation of the Banking Law, 1997-2009*, which is on its website (www.centralbank.gov.cy).

- *The Issue of Special Government Bonds Law, 2009*

The CBC, in cooperation with the Ministry of Finance, proceeded with the preparation of the *Issue of Special Government Bonds Law, 2009* and the Decree of the Minister of Finance pursuant to article 11 of the said law. The law

was enacted by the House of Representatives in October 2009 and aims at enhancing liquidity in the Cyprus economy in the context of the adverse effects of the global economic crisis. The law provides for the issue to banks of special government bonds up to a total amount of €3 billion for a maximum term of three years.

The bonds are issued against payment in the form of commission and adequate collateral to banks incorporated in the Republic of Cyprus which possess a banking licence from the CBC or the Commissioner of the Authority for the Supervision and Development of Cooperative Societies. The allocation of bonds is made on the basis of the domestic market share of each bank's business and housing loans. Eligible banks may use the bonds only as collateral for obtaining funding from the ECB and/or the interbank market. The funds raised in this way may only be used for the granting of housing loans and loans to small and medium-sized enterprises under competitive terms. As at 31 December 2009, the total amount of special government bonds allocated to banks reached €2,2 billion.

- *Implementation of the Calculation of Capital Requirements and Large Exposures Directive of 2006*

During 2009 the CBC continued its contacts and meetings with banks for clarifying various aspects of the above directive so as to achieve its correct and consistent implementation and

to ensure a uniform compilation of the capital adequacy returns submitted to the CBC, on the basis of the Common Reporting Framework (COREP). Furthermore, the CBC is in the process of amending the above directive in accordance with EC Directive 2009/111/EC. The procedure is expected to be finalised by mid-2010.

- *Amendment of the Framework of Principles of Operation and Criteria of Assessment of Banks' Organisational Structure, Internal Governance and Internal Control Systems Directive of 2006*

The amendment of the 2006 directive mainly concerns the implementation of stricter criteria regarding the assessment of the independence of members of the board of directors and the submission of related reports to the CBC. It also aims at strengthening the presence and role of the non-executive and independent directors on the various board committees. Furthermore, it requires the establishment of new committees at the board level.

An Annex titled "High level guidelines on remuneration policies" was added to the directive. This prescribes the principles for remuneration policies and bonuses of senior executives of banks.

- *Directive issued in accordance with the Prevention and Suppression of Money Laundering Activities Law*

Under the *Prevention and Suppression of*

Money Laundering Activities Law, 2007, the CBC supervises banks and money transfer businesses for the purpose of assessing the level of their compliance with the requirements of the law and the directives issued by the CBC for the prevention of money laundering and terrorist financing.

In February 2009, the CBC issued a revised directive to money transfer businesses, in accordance with the provisions of the aforementioned law. The directive requires the introduction of new internal practices and procedures for strengthening the effectiveness of the prudential measures against money laundering and terrorist financing.

The CBC, in cooperation with the Unit for Combating Money Laundering, has prepared a bill amending the above law, which has been approved by the Council of Ministers and submitted to the House of Representatives for enactment. The bill aims at the better implementation of existing provisions of the law and the harmonisation of national legislation with various acts of the EU.

- *Guidelines issued to banks*

During the year under review, the CBC issued the following:

- (a) Guidelines to banks incorporated in the Republic of Cyprus with regard to the submission of an application to the CBC for: (i) the establishment of a branch in a third country; (ii) the establishment of a

representative office outside the Republic of Cyprus; (iii) the holding of share capital in a subsidiary company to be incorporated outside the Republic for the purpose of carrying on banking business; and (iv) the acquisition of control in a bank incorporated outside the Republic.

- (b) Policy statement on the licensing of banks in the Republic of Cyprus and guidelines on the information which must be included in an application for a licence.
- (c) Guidelines to banks incorporated in other member states of the EU on the freedom of establishment and the freedom to provide services in the Republic of Cyprus.
- (d) Guidelines to banks incorporated in the Republic of Cyprus on the freedom of establishment and the freedom to provide services in other EU member states.

- *Document titled "Communication between the CBC and the Approved Auditors of Banks"*

According to the *Banking Law*, the auditors of banks are required to report to the CBC any fact or decision that comes to their knowledge during their audit which may constitute a material breach of laws or regulations that govern the conduct of banking business or materially affect the continuous functioning of the bank or lead to a refusal to certify the accounts or the expression of reservations in the audit report. Furthermore, according to the law the CBC is empowered to convene trilateral meetings

with every bank and its approved auditor as well as bilateral meetings with the approved auditor of a bank for the purpose of discussing matters relevant to the CBC's supervisory responsibilities.

The document titled "Communication between the CBC and the Approved Auditors of Banks", was sent to both banks and their approved auditors. The document sets out the framework on the arrangements of trilateral meetings and describes situations and conditions under which the CBC may convene a bilateral meeting with the approved auditor of a bank, as well as cases where reporting to the CBC needs to be made by an approved auditor in accordance with the *Banking Law*.

Developments in the banking sector

During 2009 global economic conditions deteriorated as a consequence of the financial crisis that erupted in the US in 2007. The adverse effects of the crisis on the economies of both Cyprus and Greece had a significant negative impact on the profitability of the banks supervised by the CBC. In this respect, the unfavourable economic conditions led to a significant increase in the provisions for doubtful debts while the low level of interest rates in the euro area and the US, the sharp increase in the cost of deposits and the sharp deceleration in the growth of credit restricted the increase in the net income of banks. However, despite the adverse economic environment the banks supervised by the

CBC remained profitable.

The CBC notes with satisfaction the partial reduction in the cost of deposits which, at the end of 2008, had reached abnormally high levels. However, it is of concern to the CBC that the prevailing level of the cost of deposits is still relatively high, which, through its impact on interest rates to borrowers, adversely affects the real economy. Consequently, the CBC considers that a further reduction in the cost of deposits by both banks and co-operative credit institutions will be to their benefit and to the benefit of the economy as a whole.

Furthermore, despite the unfavourable economic environment, the domestic banking system remains sound with a strong capital base and adequate liquidity. In this connection, it is noted that the efforts made by banks during 2009 to strengthen their capital base through new issues of hybrids and bonds were very successful. Moreover, the issuance of covered bonds and the securitisations of loans carried out in Greece resulted in the strengthening of banks' liquidity. These developments are a firm indication that the credibility and good standing of banks supervised by the CBC remain intact despite the volatility of the economic environment in which they operate.

The specific measures taken by the CBC in the past have been crucial in preserving domestic financial stability. These measures include the restriction of banks' exposures to

risks related to the property market and the maintenance of adequate and qualitative liquidity, which protects banks even in periods of severe financial stress. Furthermore, the continuous strengthening of the risk management procedures and the internal governance framework of banks, are important factors in supporting the financial soundness of the domestic banking system. The CBC's role is fundamental as the strengthening of banks' internal procedures and governance is achieved through the CBC's supervisory guidance.

The year under review can be described as one of challenges regarding the overseas operations of the banks supervised by the CBC. The economies of south-eastern Europe, particularly Greece, in which Cypriot banks operate, were adversely affected by the global economic crisis. In response to these developments, the efforts of banks focused on minimising the adverse effects of the crisis. It must be noted that the crisis affected the economies of Cyprus and Greece with a time lag. The CBC will continue to monitor and supervise the operations of banks, always in close cooperation with their management, in order to ensure that their sound financial position is safeguarded.

The CBC expects 2010 to be another difficult year for the world economy and the international financial system. The global economy and the capital markets remain vulnerable while the risks from high fiscal and

budget deficits have increased significantly. Additionally, the challenges faced by the economies of Cyprus and Greece in order to overcome the effects of the crisis and to recover are considerable. However, the CBC emphasises that the domestic banking system is sound, with a strong capital base, adequate liquidity and a strengthened internal governance framework, factors which will enable it to address the coming challenges successfully.

Cooperation with other domestic and foreign supervisory authorities

In accordance with the memorandum of understanding signed between the supervisory authorities in November 2003, the CBC has continued its regular meetings with the other competent supervisory authorities in Cyprus for the purpose of exchanging information and cooperating on issues of common interest. Regarding the cooperation with foreign supervisory authorities, the CBC continued to participate actively in the meetings of the CEBS and its working groups. The main objective of the CEBS is to advise the European Commission on supervisory and regulatory issues concerning the banking sector and to contribute to the consistent application of Community legislation as well as the convergence of supervisory practices by member states.

Particular importance is placed by the CBC

in developing bilateral ties and contacts, mainly with those supervisory authorities which supervise banks that offer services in Cyprus or on a cross-border basis without establishment, as well as with the supervisory authorities of countries where subsidiaries and branches of Cypriot banks are operating. In this connection, in 2009 the CBC actively pursued the negotiation and signing of memoranda of understanding with a number of foreign supervisory authorities. This is in line with the relevant recommendations of the Basel Committee on Banking Supervision, which aim at ensuring effective supervision of the cross-border activities of banks.

During the year under review, the CBC signed memoranda of understanding with the supervisory authorities of Guernsey, Latvia and Poland whereas the memorandum of understanding with Romania was renegotiated and updated. Therefore, the total number of memoranda of understanding already signed in the field of banking supervision is currently 28. The CBC is in the process of negotiations for the signing of memoranda of understanding with other overseas supervisory authorities.

4.2 Financial Stability

Financial stability monitoring and assessment

In exercising its role of safeguarding the stability of the financial system, the CBC regularly monitors the cyclical and structural

developments in the financial sector, mainly in the banking system, as well as the developments in the macro-financial environment with a view to assessing potential risks to financial stability and the financial system's shock-absorption capacity. The results of the above assessment are published in the CBC's biannual *Economic Bulletin*. The *Bulletin* includes a section on financial stability conditions, which provides an analysis of the main sources of risk for the stability of the domestic financial system emanating from the macro-financial environment, by focusing on the household, non-financial corporate and real estate sectors. As regards the domestic financial system itself, the *Bulletin* contains a brief description of the key developments in the financial markets as well as the main structural developments in the banking sector. The *Bulletin* also provides an analysis of banks' financial condition and an assessment of the most significant risks facing the banking sector, which constitutes by far the largest component of Cyprus's broad financial system.

Stress testing of the banking sector

In 2009 the CBC continued to conduct its regular stress testing exercises with the aim of assessing the banking sector's capacity to withstand potential shocks. In the single-factor sensitivity analyses that were carried out, based on the "top-down" approach, a number of exceptional but plausible shocks

concerning changes in individual risk factors, namely credit risk, market risk (interest rate risk, exchange rate risk and equity price risk) and liquidity risk were applied. In the "bottom-up" stress testing exercises, in which four systemically important banks participated, a range of hypothetical adverse shocks were considered. These related to changes in individual risk factors, namely interest rate risk, exchange rate risk, asset price risk (equity price risk and real estate price risk), credit risk and net interest margin risk. For liquidity risk, a number of scenarios incorporating various combinations of individual shocks were applied. Furthermore, several multi-factor scenarios that included combinations of individual shocks were considered. The aggregate results of both stress testing exercises based on the two aforementioned approaches suggest that the Cyprus banking sector's shock-absorption capacity remains strong.

IMF assessment of the Cyprus financial sector

Following the IMF mission's visit to Cyprus during the period September-October 2008, under the Financial Sector Assessment Program (FSAP), as well as the IMF's visit in June 2009 based on the Article IV Consultations, the report on assessment of the stability of Cyprus's financial system was published by the IMF in November 2009. It must be noted that the IMF FSAP assessment aims at assessing the stability of a country's

financial system as a whole and not that of individual financial institutions operating in the country. In the case of Cyprus, the CBC had the overall coordinating role in the assessment process. Despite certain challenges that still remain, the overall outcome of the assessment was positive.

National Financial Stability Committee

In 2009 the CBC continued to chair the National Financial Stability Committee. This was set up in accordance with the provisions of the memorandum of understanding between the CBC, the Authority for the Supervision and Development of Cooperative Societies, the Cyprus Securities and Exchange Commission, the Insurance Companies' Control Service and the Ministry of Finance in the field of financial stability signed in November 2007. The task of the aforementioned Committee is to discuss financial stability issues, including financial crisis management issues. In the aftermath of the global financial crisis, the role of the Committee has acquired particular significance for our country.

Deposit Protection Scheme

As regards the Deposit Protection Scheme, a number of amendments to the relevant Regulations were published in the Cyprus Official Government Gazette in July 2009 aiming to enhance the effectiveness and efficiency of the Scheme. These amendments

included, *inter alia*: the increase of the statutory deposit protection coverage per depositor and per bank from €20.000 to €100.000; the extension of the coverage to include deposits denominated in all currencies; the reduction of the payout period in accordance with the relevant EU directive; the increase in the level of the minimum initial and maximum percentage contributions of banks; the increase of the Fund's basic capital; the abolition of the maximum limit on the amount that the Fund may borrow; and the abolition of co-insurance so that depositors' claims up to €100.000 can be fully satisfied. The above amendments have rendered the Fund at par with similar funds in the EU and especially the Hellenic Deposit Guarantee Fund. This latter development is particularly important considering the interconnectedness of the Cyprus and Greek banking systems due to the cross-border presence of Cypriot banks in Greece and Greek banks in Cyprus.

Participation in the committees of the ESCB and in high-level meetings

In 2009 members of the Financial Stability Department continued to participate actively in the meetings and workings of the Banking Supervision Committee (BSC) of the European System of Central Banks and its working groups, which focus on issues related to the stability of the financial system. It must be noted that the mandate of the BSC includes

the monitoring and assessment of the cyclical and structural developments in the EU banking sector from a financial stability perspective as well as the analysis of the impact of regulatory and supervisory requirements on the stability and structure of the EU financial system. In addition, the BSC aims at promoting the cooperation and information exchange between the central banks and banking supervisory authorities of EU member states on issues of common interest, such as financial crisis management matters. The senior management also participated in the regular high-level meetings with the domestic financial supervisory authorities chaired by the CBC as well as the meetings with the chief executive officers of banks operating in Cyprus where, *inter alia*, issues related to financial stability are discussed.

4.3 Regulation of Near Banking Services

During 2009 the CBC retained its status as the competent regulatory and supervisory authority for specialised financial sectors, such as private collective investment schemes and electronic money. It also maintained its responsibility for overseeing other functions, such as the administration of the Investors Compensation Fund for Bank Customers and the coordination of the activities of the committees for investigating complaints.

In collaboration with the Ministry of Finance, the Securities and Exchange

Commission, the Law Service of the Republic and certain other public bodies, the CBC concluded the review of the following legislative bills:

- (a) The bill regulating the activities of financial leasing companies;
- (b) The bill regulating the activities of trust and company service providers;
- (c) The bill regulating spot foreign exchange business;
- (d) The Consumer Credit Agreements Bill.

A more detailed analysis of the areas of responsibility is provided below.

International collective investment schemes

During 2009 a large number of applications was submitted for the establishment of private collective investment schemes in the form of either an investment company or a limited liability partnership. In particular, during the year under review, seven new private collective investment schemes were authorised, raising the total number of such schemes operating at the end 2009 to 49. At the same time, a considerable number of applications had already passed successfully the initial reviewing process and applicants are now standing close to obtaining a licence. In exercising its duties, the CBC collaborated closely with the Registrar of Companies and the custodians/trustees of the aforesaid schemes.

Electronic money institutions

By the end 2009, only one company was authorised by the CBC to operate as an electronic money institution (EMI), while eight other institutions authorised in other EU member states continued to provide services from Cyprus, in accordance with the relevant mutual recognition arrangements established under the *acquis communautaire*.

In response to the continued interest expressed in the establishment of EMIs, the CBC organised informative meetings with prospective applicants. It provided appropriate documentation describing the modus operandi of the said institutions and indicating the particular terms and conditions which must be fulfilled for a licence to be granted, while highlighting the benefits which e-money holders enjoy.

On 10 October 2009, the new Directive on the taking up, pursuit and prudential supervision of the business of EMIs was issued by the EU with a view to replacing the existing one. The new directive is expected to be transposed to national law by 30 April 2011.

Committee for investigating complaints

Throughout the year under review, the Committee for the Investigation of Complaints Arising From the Use of Electronic Payment Instruments, which operates under the auspices of the CBC, continued the

investigation of official complaints submitted by bank clients regarding transactions effected electronically or transactions executed by electronic payment instruments (debit/credit cards). By the end 2009, four cases were before the Committee for review.

Investor compensation fund for clients of banks

During 2009 the CBC's Regulation of Near Banking Services Section performed its administrative duties relating to the operation of the Investor Compensation Fund for Clients of Banks, in conformity with the policy and decisions adopted by the Fund Management Committee. On the basis of guidelines adopted during various consultations held at community level for the purpose of reviewing the regulations which govern such funds, the CBC cooperated closely with the Ministry of Finance with a view to adopting appropriate implementing measures.

Regulation of the activities of trust and company service providers

The CBC completed the drafting of the new bill which regulates the activities of trust and company service providers, the main object of which is the regulation of the activities of persons involved in the establishment of companies and/or the provision of company administration or trust services.

The final text was submitted to the Ministry of Finance which is expected to

present the bill to the House of Representatives for approval in early 2010.

Spot foreign exchange services

During 2009 the CBC reached an agreement with the Cyprus Securities and Exchange Commission, the aim of which is to specify the particular regulatory and supervisory duties of the two authorities with regard to spot foreign exchange business. Pursuant to this agreement, the CBC shall be the competent authority for authorising and supervising persons providing foreign exchange services, in cases where the underlying transactions result in the physical delivery of the agreed foreign currency or in a material settlement in cash within a time period of two days.

Leasing services

The CBC, in cooperation with the Ministry of Finance and the Authority for the Supervision and Development of Cooperative Societies, completed the drafting of the bill which governs financial leasing.

The new bill, which has already been reviewed by the Law Service of the Republic, is expected to be enacted into law in early 2010.

Consumer credit agreements

An officer from the CBC's Regulation of Near Banking Services Section was appointed by the Governor of the CBC as a member of the committee established for the purpose of

reviewing the legal framework governing consumer credit agreements. A new bill is already in place, the aim of which is to harmonise national law with the *acquis communautaire*. Its purpose is to afford a well-balanced, high-level protection to consumers who enter into credit agreements.

Apart from the CBC's representative, the other participants in the aforementioned committee come from the Ministry of Commerce, Industry and Tourism, the commercial banks and the various consumers associations.

4.4 Payment and Settlement Systems

The smooth and orderly functioning of an economy requires safe and efficient means of effecting payments. In addition, payment, clearing and settlement systems are important for maintaining financial stability because they are the means through which economic disturbances are transmitted from one financial sector to another. In recent years, substantial increases in financial market activity, coupled with rapid advances in technology, have brought to the fore the importance of the safety and efficiency aspects of payment, clearing and settlement systems.

For these reasons, the existence of a proper legal framework as well as infrastructure, both at the European and local level, are of primary importance. Close cooperation between the CBC and the banking community is also vital

for ensuring timely and effective responses to developments, whether these are connected to EU/Eurosystem membership or not. Various committees, such as the Consultative Payments Committee, the Committee of the Cyprus Clearing House for cheques and the National Coordinating Committee for the Single Euro Payments Area (SEPA), facilitate the effective exchange of information and coordination among all parties involved.

Legal framework

The role of the CBC concerning payment, clearing and settlement systems, as envisaged by the *acquis communautaire*, is based on the *Central Bank of Cyprus Law, 2002-2007*. In particular, section 6(2)(g) specifies as one of the main responsibilities of the CBC the promotion, regulation and oversight of the smooth operation of payment, clearing and settlement systems. Furthermore, in accordance with this law, the CBC may administer, participate in or become a member of any payment, clearing and settlement system and may place under its oversight any payment, clearing and settlement system that operates in the Republic. In addition, the CBC may issue directives regulating the functions and operating procedures of the systems under its oversight.

The CBC is the competent authority for designating payment and settlement systems that fall within the scope of the

provisions of the *Settlement Finality in Payment Systems and in Securities Settlement Systems Law, 2003-2006*. In addition, this law gives the CBC the right of access to any information it may deem necessary in the discharge of its responsibilities and the power to impose administrative fines on any participant for non-compliance. The CBC has designated the TARGET2-CY system and the Central Depository and Central Registry of the Cyprus Stock Exchange as systems falling under the provisions of the *Settlement Finality Law*.

During 2009 the CBC completed the preparation of a bill of law and a directive transposing EU Directive 2007/64/EC for the Payment Services in the Internal Market. The harmonising law (the *Payment Services Law, 2009*) and the harmonising CBC directive (Payment Institutions and Access to Payment Systems Directive of 2009) were published in the Official Gazette of the Republic on 27 November 2009 and have been in force as from that date. As provided in the EU directive, the law and the CBC directive prescribe:

- The transparency rules and provision of information obligations that should be observed in relation to payment services.
- The rights and obligations of payment service users and providers (banks, co-operative credit institutions, payment institutions).
- The conditions that need to be fulfilled by the existing payment institutions as well as

new payment institutions, in order to obtain and maintain their operation license.

Payment and securities settlement systems operating in Cyprus

There are currently six payment, clearing and settlement systems operating in Cyprus. These are TARGET2-CY, the Cyprus Clearing House for cheques, the payment cards clearing and settlement system, the retail credit transfers system (JCCTransfer), the government credit transfers system, and the Cyprus Stock Exchange clearing and settlement system. These systems, with the exception of the government credit transfers system and the Eurosystem's TARGET2, are described in the ECB publication 'Payment and securities settlement systems in the European Union' issued in August 2007 (www.ecb.int). The CBC is the operator of TARGET2-CY, the Cyprus Clearing House for cheques and the government credit transfers system.

Single Euro Payments Area (SEPA)

The CBC supports the efforts of the European banking sector for the formation of the legal and regulatory framework as well as integrated infrastructure that will allow the adoption of an advanced and reliable network for retail payments leading to the realisation of SEPA.

For the realisation of this project in Cyprus, a National Coordination Committee was

established under the chairmanship of the CBC. The Committee's task is to coordinate the efforts of the Cyprus banking sector in its preparations to provide SEPA compliant products relating to credit transfers, payment cards and direct debits. The first two were successfully launched in Cyprus in January 2008 and since then a gradual increase in volume has been recorded. SEPA direct debits will start being offered by Cypriot banks during 2010. The CBC supports the Government in its efforts to achieve widespread use of SEPA compliant products. In this context, since October 2009 the CBC has been connected with the payments mechanism of the Deutsche Bundesbank and can send and accept SEPA compliant payments. As far as cross-border government payments are concerned, since the last quarter of 2009 incoming transfers as well as outgoing payments for pensions are being processed through SEPA compliant payment instruments. The use of IBAN is already mandatory for domestic electronic government payments.

Oversight of payment and settlement systems

The CBC, in accordance with the powers vested in it by law, has placed under its oversight the payment, clearing and settlement systems operating in Cyprus. In exercising these duties it applies, as far as possible, the policies and methodologies

adopted by the Eurosystem.

- *Assessment of the Central Depository and Central Registry of the Cyprus Stock Exchange (CDCR)*

The CDCR was assessed in 2008-2009 in the context of a unified assessment of European depositories and their links. The assessment was performed on the basis of the standards applicable for the use of securities settlement systems in ESCB credit operations. As in the previous assessment in 2007, the CDCR was considered as eligible for ESCB credit operations. At the same time, a number of recommendations which will make the CDCR fully compliant with all standards were included in the assessment report and accepted by the Board of the Cyprus Stock Exchange. A timetable for introducing the necessary changes was agreed between the ECB, the CBC and the Cyprus Stock Exchange, and most recommendations have been implemented.

- *Assessment of the Cyprus Clearing House for cheques and of the payment cards system of JCC Payment Systems Ltd*

During 2009 the CBC initiated assessment procedures for the Cyprus Clearing House for cheques and for the payment cards clearing and settlement system of JCC Payment Systems Ltd. Both systems are considered by the CBC as very important and, as they have been settling in euro since January 2008, they

must be assessed in line with the Eurosystem policy. The assessments are expected to be completed in 2010.

- *Collateral Central Bank Management (CCBM2) and TARGET2 Securities (T2S)*

The CBC is participating in two important Eurosystem infrastructure projects relating to payment and securities settlement systems, namely CCBM2 and T2S. The CCBM2 project aims to increase the efficiency of the Eurosystem's collateral management systems. The T2S project aims to deliver a single integrated securities market for financial services by providing a single, borderless pool of pan-European securities as well as a core, neutral and state of the art settlement process.

Other developments

- *Wider access to the Central Information Register for Issuers of Dishonoured Cheques (CIR)*

The CIR was established in 2003 under the auspices of the CBC. The listing of issuers of dishonoured cheques results in the freezing of all of their current accounts with all banks. In order for the CIR to become a more effective deterrent, access to the CIR's basic information was extended as from July 2009 to all interested parties, via a service provider.

The directive governing the operation of the CIR was amended in December 2009, making it possible for greater account to be

taken of the period within which dishonoured cheques are settled when assessing whether a listed person is to be delisted or not, particularly when it can be proved that such cheques have been settled within one month of the date of their listing.

- *TARGET2*

TARGET2 (Trans-European Automated Real-time Gross settlement Express Transfer system), was developed by the central banks of Germany, France and Italy and came into operation in November 2007, while migration from the previous system, TARGET, was completed in May 2008. TARGET2 offers the possibility of automated real-time and irrevocable settlement of payments in euro, in central bank money. It is used for the settlement of Eurosystem central bank transfers as well as for inter-bank transfers of high value or any other transfers. More information on TARGET2 is available on the ECB webpage at www.ecb.int/paym/t2/html/index.en.html.

Cyprus participates in TARGET2 through TARGET2-CY, which is governed by the relevant CBC directive issued by virtue of the *Central Bank of Cyprus Law*. Also of relevance is the Directive for the provision of intraday credit to participants in TARGET2-CY and any other system managed by the CBC. In addition to the CBC, another 14 financial institutions which operate in Cyprus are direct participants in TARGET2-CY while

another five participate indirectly through other European financial institutions.

- *Cheque truncation*

Following the appropriate amendment by the House of Representatives to the criminal code for the return of cheques by electronic means, the CBC has approved the procedures proposed by the group of interested banks for the electronic interbank exchange of cheques in the form of images. The goal is to reduce the cheque processing costs and the time taken for the clearing of cheques. Electronic cheque clearing is expected to be introduced in 2010 with the participation of almost all banks operating cheque accounts for their customers.

- *Companies providing intermediation services for the transfer of funds*

Up until 27 November 2009, the regulation and oversight of intermediation services in the transfer of funds was carried out in the context of CBC Directive ΚΔΠ 659/2003 acting within the context of its role in the promotion, regulation and oversight of payment systems operating in the Republic. The CBC's aims were twofold: to protect the users of such services and to ensure that these services were not used in illegal activities. Under this framework, prior to 2009 the CBC issued an operating license to seven companies while one of these licenses was withdrawn at the beginning of 2009.

As from 27 November 2009, the provision of these services is governed by the *Payment Services Law, 2009* and the Payment Institutions and Access to Payment Systems Directive of 2009. The previous framework continues to apply to the existing providers of such services for a transitional period, to be determined by the CBC, within which they shall submit an application for licensing under the new framework. By the end of 2009, the CBC received four new applications for a payment institution license, while more than 20 notifications were received from other European supervisory authorities for licensed payment institutions that intend to offer their services in Cyprus.

4.5 Currency

Issuance of euro banknotes and coins

During 2009 the value of the currency issued by the CBC increased by 13% reaching €1.383,1 million. The €500 and €50 euro banknotes exhibited the largest increase and their share in the total value of banknotes increased to 26,4% and 55,4%, respectively, from 19,4% and 48% in 2008. The €10 banknote exhibited a significant decrease, with returns to the CBC exceeding the amount issued by the CBC (negative issuance). The average denominated value of banknotes in circulation was €74,3 in 2009 compared with €48,6 in 2008 (in the euro area it was €59,11 and €58,15 at the end of 2009 and 2008, respectively).

Table 4.1 Euro banknotes and coins issued
(end of period)

Denomination	2009		2008		Percentage change 2009/2008
	Value (€ million)	Share (%)	Value (€ million)	Share (%)	
Banknotes					
€500	343,8	26,4	223,6	19,4	53,8
€200	53,4	4,1	48,2	4,2	10,8
€100	161,8	12,5	160,5	13,9	0,8
€50	720,9	55,4	552,3	48,0	30,5
€20	45,6	3,5	144,5	12,6	-68,4
€10	-31,2	-2,4	11,3	1,0	-376,1
€5	6,9	0,5	9,9	0,9	-30,3
	1.301,2	100,0	1.150,3	100,0	13,1
Coins					
€2	38,9	47,5	33,8	46,1	15,1
€1	19,4	23,7	18,7	25,5	3,7
€0,50	9,3	11,4	8,8	12,0	5,7
€0,20	6,8	8,3	5,9	8,0	15,3
€0,10	3,9	4,8	3,2	4,4	21,9
€0,05	2,4	2,9	1,9	2,6	26,3
€0,02	0,8	1,0	0,7	1,0	14,3
€0,01	0,4	0,4	0,3	0,4	33,3
	81,9	100,0	73,3	100,0	11,7
Total	1.383,1		1.223,6		13,0

Source: CBC.

Detailed data on the currency issued per denomination as well as comparative data for 2008 is shown in **Table 4.1**.

Ensuring the authenticity and quality of euro banknotes in circulation

All banknotes returned to the CBC are checked for authenticity and fitness before recirculation using high-tech processing machines.

During the year under review, 54,7 million pieces of euro banknotes were processed, out of which 13,9% were considered as unfit and were destroyed.

With the aim of maintaining the integrity of the currency and strengthening the public's confidence in it, in December 2004

the Eurosystem adopted the Banknote Recycling Framework for euro banknotes, which was implemented by the CBC following the entry of Cyprus in the euro area. Specifically, the CBC issued a directive for the implementation of the Framework, according to which credit institutions and other professional cash handlers have an obligation to implement the Framework with effect from 1 January 2010. This implies the checking of all banknotes for authenticity and fitness according to the minimum sorting standards of the Eurosystem before they are reissued to the public by credit institutions.

During 2009 the special committee which

Table 4.2 Counterfeit banknotes per quarter
(no. of pieces)

Year	Quarter				Total
	First	Second	Third	Fourth	
2009	73	106	218	207	604
2008	192	116	115	153	576

Source: CBC.

was set up for the adoption and implementation of the Framework, and which includes the credit institutions, had frequent meetings for the purpose of coordinating and monitoring the progress of the Framework's implementation.

The CBC also organised seminars to train the cashiers of credit institutions for proper authenticity and fitness checking and sorting of banknotes.

Counterfeit euro banknotes detected in Cyprus during 2009

During 2009 604 counterfeit euro banknotes of various denominations were detected, compared with 576 pieces in 2008. Quarterly data are shown in **Table 4.2**.

Cyprus exhibited the lowest percentage of counterfeits withdrawn from circulation during 2009, which was 0,06% of the total counterfeits detected by all euro area countries in the same period.

The €50 banknote was the most frequently counterfeited denomination and represents 56,3% of the total. The total corresponding percentage for the €20, €50 and €100 denominations is 83,3% of the total. Detailed data are shown in **Table 4.3**.

Most counterfeits withdrawn from

Table 4.3 Counterfeit banknotes

Denomination	€5	€10	€20	€50	€100	€200	€500
% of total	4,8	0,7	13,9	56,3	13,1	10,4	0,8

Source: CBC.

circulation were detected by the cashiers of credit institutions.

During 2009 a memorandum of understanding was signed with the Cyprus Police aimed at further strengthening cooperation in the protection of the euro against counterfeiting.

Rationalisation of the cash cycle

In view of the implementation of the Banknote Recycling Framework for euro banknotes as from 1 January 2010 and the consequent large increase in the quantities of banknotes to be transported and processed, the CBC decided to introduce a "Notes Held to the Order of the Central Bank" scheme. The scheme allows the banks to hold, under certain conditions, banknotes and coins for the CBC's account. The objective of the scheme is the creation of a more efficient framework for the processing and recirculation of banknotes, reducing the costs and strengthening the security of the cash cycle.

At the same time, the CBC, aiming towards a more efficient cash management, decided to introduce a new high-tech system, known as CashSSP, which is already used by four other Eurosystem national central banks. In cooperation with the central banks of the

Eurosystem, which developed and use the system, all necessary preparations were made during 2009 and the system will be implemented in early 2010.

Numismatic developments

- *Commemorative coin for the 10th anniversary of EMU*

The first Cyprus commemorative euro coin was issued in January 2009, within the framework of a decision of the euro area member states for minting a common commemorative coin for the 10th anniversary of EMU. The total mintage of Cyprus commemorative coins was 1.000.000, of which 20.000 coins of special uncirculated condition were placed in capsules for collectors. Out of these 20.000 coins, 7.000 were placed in cases, also for collectors.

- *Collector set*

In October 2009, the CBC issued a collector set of the Cyprus euro coins minted in 2009, in

brilliant uncirculated condition. The set also includes the €2 commemorative coin, issued in 2009 on the occasion of the 10th anniversary of EMU. The coins are set in a three-ply brochure placed in a case. The brochure and case depict ancient mosaics from the House of Dionysos in Paphos. The total issue was 15.000 sets which were sold very successfully in Cyprus and abroad.

- *Sales of euro coins and other numismatic items*

The interest of dealers and collectors for Cyprus euro coins continued during 2009. Coins in uncirculated condition with an approximate value of €1 million were sold for collector purposes.

- *E-commerce website*

In October 2009, an e-commerce website (<http://eshop.centralbank.gov.cy>) was set into operation for the sale of collector and other numismatic items issued by the CBC. The site provides a regular and complete update of Cyprus numismatic issues and also facilitates the purchase of Cyprus collector coins and other numismatic items.

- *Award of a prize for the Cyprus €2 coin*

The Cyprus €2 coin was awarded first prize as the “Best Trade Coin” in an international competition organised in 2009 by Krause Publications, the American publisher of “World Coin News”. The winning coin is the



common €2 circulation coin which depicts a cross shaped idol dating back to the chalcolithic period (3000 BC). The idol is an example of Cyprus's prehistoric art and civilization. In the view of the judging panel, the coin possesses all-around appeal both from the aesthetic and commercial viewpoint and best meets the basic considerations of actual circulation as a monetary unit.

Withdrawal of the Cyprus pound

The withdrawal of the Cyprus pound, which was replaced by the euro on 1 January 2008, continued during 2009.

Banknotes with a value £4,7 million (€8 million) and coins with a value £0,5 million (€0,9 million) were withdrawn from circulation. On 31 December 2009, the value of Cyprus pounds (banknotes and coins) not yet exchanged for euro was £65,2 million (€111,4 million) or 10,4% of the amount in circulation before the introduction of the euro. Of this amount 67% represents banknotes and 33% coins.

The period for exchanging Cyprus pound coins ended on 31 December 2009. The CBC will continue to exchange Cyprus pound banknotes until 31 December 2017.

4.6 Activities in the Financial Markets

On 31 December 2009, the CBC's reserves, including gold holdings valued at €342,4 million, amounted to €3.641,5 million compared with €3.650,6 million at the end of

2008. The change in the level of the reserves during the year resulted from net foreign currency flows, interest received from investments, the revaluation of investments at market prices and the fluctuation of foreign currencies against the euro.

According to the CBC's Investment Policy Framework, the management of reserves in euro, foreign currencies and gold focuses on the long-term maximisation of the return on reserves, without sacrificing other long-standing objectives of critical importance, such as the safety of the reserves and overall capital preservation. The income derived from reserves management comprises the major source of financing of the CBC's operations, thus safeguarding its financial independence.

The CBC's investment policy provides for the investment of the currency and gold reserves in approved asset classes, using approved financial instruments. Transactions are executed and processed through approved counterparties, such as banking institutions or investment banks. The cornerstone of the investment policy is the use of selected benchmark portfolios. This practice facilitates not only the comparative measurement of returns but also the assessment of the inherent risks of the real portfolios against parameters that remain stable over time.

During 2009 the CBC's general investment strategy framework, which determines, *inter*

alia, the approved asset classes as well as the benchmark portfolios, has proven to be the most appropriate choice under the prevailing market conditions as it has protected the value of the reserves amid the financial turmoil and the global investment uncertainty. For this reason, real portfolio investments, especially those comprised of high quality government and supranational securities, not only have not incurred losses but have gained in market value.

The framework for monitoring and controlling the inherent risk related to the CBC's reserves management operations is continuously monitored and updated according to existing market conditions.

- *Foreign exchange risk*

Foreign exchange risk refers to the risk of incurring losses in the market value of investments due to fluctuations in the exchange rate of the euro against other currencies in which the CBC maintains reserves.

During 2009 the currency distribution of reserves remained essentially unchanged compared with the previous year. The CBC held reserves primarily in euro and dollars and, to a lesser degree, in sterling. The biggest portion of foreign exchange risk was hedged through the use of foreign exchange swaps. This strategy averted potential foreign exchange losses due to the wide fluctuations in the exchange rate of the

euro against both the dollar and sterling during the year.

- *Interest rate risk*

Interest rate risk is the risk of loss in the market value of investments due to fluctuations in market interest rates. Having in mind the mitigation of interest rate risk, real portfolios were gradually adjusted to replicate the revised benchmark portfolios with lower duration that were adopted during the year. This strategy was aimed at avoiding excessive losses due to a potential drop in the market price of securities, while improving the return over time on reserves relative to the risks undertaken.

Interest rate risk was further eased by the increase in the maximum allowed deviation of the modified duration of the investment portfolios from the duration of their corresponding benchmark portfolios. This allowed for further reduction in the exposure of investment portfolios to interest rate risk as compared to the corresponding benchmark portfolios. As in previous years, an additional constraint applied in that the remaining life to maturity of all bond investments could not exceed five years. Finally, the CBC further lessened its exposure to interest rate risk by maintaining its policy of keeping part of its euro reserves as 'investments held to maturity'.

- *Credit risk*

Credit risk refers to the risk that a counterparty

or an issuer of securities fail to meet their contractual or legal obligations for the entire or part of the agreed amount during the period of the contract (default risk). Credit risk also includes the risk of loss in the market value of the investments, due to a downgrading of the credit rating of an issuer of securities (downgrade risk).

During 2009, when financial markets were quite unstable, time deposit placements were maintained at very low levels, while the biggest portion of reserves was invested in government securities of countries which have traditionally exhibited political and economic stability and had high credit ratings. Furthermore, during 2009 the CBC assessed the possibility of including alternative issuers in the benchmark portfolios with the aim of enriching the list of approved issuers, thus further diversifying investment alternatives.

- *Operational risk*

Operational risk refers to the risk of loss in the market value of the investments or to the risk of actual loss of the investments, due to errors arising from inadequate procedures and systems and/or errors and omissions attributed to human factors.

For the smooth and secure reserves management operations, the CBC maintained its standing policy of operational risk minimisation and of strict functional segregation of duties in relation to the:

- 1) Conclusion and execution of transactions in investment operations and payments as well as in the operations for the implementation of the monetary policy of the Eurosystem.
- 2) Settlement of the transactions.
- 3) Monitoring of various risk exposures and overall compliance with the risk management framework.

- *Legal risk*

Legal risk refers to the absence of a legal framework covering the CBC's activities or to the inadequacy of such a framework.

Within the framework of mitigating this risk, negotiations continued with counterparties for the conclusion of Framework Master Agreements to cover transactions related to the hedging of foreign currency and gold. To this end, during 2009 the CBC concluded negotiations and signed and implemented bilateral agreements, based on internationally approved standards, with a number of banking institutions that are included in the list of approved counterparties.

Participation in the management of the foreign exchange reserves of the ECB

The management of ECB reserves is decentralised and is conducted by the Eurosystem national central banks that have adopted the euro and which act as agents of the ECB. The CBC participates in the management of ECB reserves under a pooling

arrangement of their respective shares with the Bank of Greece.

Implementation of monetary policy

On behalf of the ECB, which is responsible for formulating monetary policy in the euro area, the CBC participates along with the other national central banks in the euro area in the implementation of the single monetary policy that is determined by the decisions and guidelines of the ECB's Governing Council. Consequently, the credit institutions that reside in and operate from Cyprus participate in and have access through the CBC to the open market operations and standing facilities of the Eurosystem.

The implementation of monetary policy in 2009 was marked by additional non-standard measures of the Eurosystem, some of which had been initiated in 2008, aimed at combating the unstable conditions prevailing in the financial markets, thus ensuring that solvent banks had continued access to liquidity. These measures entailed the conduct of regular and supplementary open market operations through fixed rate tender auctions with full allotment to participating institutions, the expansion of the list of eligible assets for Eurosystem credit operations, the conduct of operations for the provision of liquidity to eligible credit institutions in dollars and Swiss francs and, finally, the conduct of longer-term refinancing

operations beyond normal periods with a duration of up to 12 months.

Participation in the covered bonds purchase programme of the Eurosystem

Since July 2009, the CBC has been participating in the covered bonds purchase programme that has been incorporated into the monetary policy implementation practices of the Eurosystem. The CBC has accordingly set up and implemented a special in-house framework that governs the conclusion and settlement of transactions under this programme.

4.7 Management of Public Debt

The CBC is, in accordance with the relevant provisions of the *Central Bank of Cyprus Law*, the administrator of the public debt, including the issue of government securities. The Council of Ministers, acting in accordance with the provisions of the *Central Bank of Cyprus Law*, has decided that this responsibility will be transferred from the CBC to the Ministry of Finance as from 1 August 2010. The CBC has assured the Ministry of Finance that it will make every possible effort to facilitate the successful transfer of responsibility. At the same time it has expressed its readiness for concluding the process the soonest possible in order to eliminate any market uncertainty during the transitional period. Given the above decision of the Council of Ministers, the CBC, in full

consultation with the Ministry of Finance, undertook all necessary actions for fulfilling the financing needs of the Government and for the effective management of the public debt during 2009. Specifically, the CBC handled the following:

- Operational and administrative matters pertaining to the issue of government securities.
- Maintenance of government security holders' register (where applicable).
- Payment of interest and the redemption of debt.
- Sourcing of foreign financing.
- Comparative evaluation of financing proposals.
- Negotiation of relevant agreements.
- Recording of the public debt.

The main objective of the management of the public debt is the achievement of the following targets:

- Securing of smooth cover of the government's financing needs through regular and continued access to the various segments of the domestic and international capital markets.
- Minimisation of the cost of the public debt, subject to the prevailing conditions in the domestic and international markets and acceptable exchange/interest rate risk levels.
- Achievement of a balanced and more extended maturity structure of the debt. This is in order to avoid a heavy bunching

of maturing debt which could potentially increase abruptly the fiscal burden and/or make the refinancing of the debt more difficult and/or less favourable than if such a refinancing was effected under more normal conditions.

Government securities

The financing needs of the Government are mainly fulfilled through the issue of treasury bills, government registered development stocks of 2, 5, 10 and 15-year duration, Euro Medium Term Notes (EMTN) and Euro Commercial Paper (ECP). Government financing through the issue of 3-year government registered development stocks and 5-year savings certificates has been suspended since September 2007, whereas financing through the issue of savings bonds has been terminated.

Treasury bills (TBs) of 13-week duration are issued either at fixed prices (for the investment of government funds administered by the CBC) or through auctions. TBs of 13-week duration are not listed on the Cyprus Stock Exchange and, therefore, no secondary market exists. TBs of 52-week duration are issued only through auction and are listed on the Cyprus Stock Exchange. The total nominal value of TBs outstanding on 31 December 2009 was €7.384,7 million compared with €6.637,3 million on 31 December 2008. On 31 December 2009, outstanding TBs held by government funds

Table 4.4 GRDS issued/matured in 2009
(€ million)

Type of Bond	Issues		Maturities
	No. of Issues	Amount	Amount
2-year ⁽¹⁾	-	-	59,8
3-year	-	-	59,1
5-year ⁽¹⁾	2	315,2	484,6
10-year ⁽¹⁾	-	-	106,8
15-year ⁽¹⁾	-	-	-
Total		315,2	710,3

Source: CBC.
1) Through auction.

administered by the CBC amounted to €7.086,7 million while banks were holding €298 million. Issues of TBs through auction with 35 and 39 weeks and 82 days duration were also effected during 2009.

Government registered development stocks (GRDS) of 2, 5, 10 and 15-year duration are issued through auction, whereas the 3-year GRDS were, before the suspension of their issue, issued at par and offered only to natural persons. The issue of government securities through auction allows lending rates to reflect market conditions. **Table 4.4** shows the GRDS new issues and the GRDS which matured in 2009.

GRDS issued through auction are listed and traded on the Cyprus Stock Exchange. In accordance with the terms of issue, the CBC

may intervene in the secondary market to maintain orderly market conditions, if it is deemed necessary. No such action was considered necessary during 2009.

Government borrowing through the issue of savings certificates (SCs) has been suspended since September 2007. The total outstanding amount of all series of SCs on 31 December 2009 was €66,2 million, a decrease of €20,8 million over the amount outstanding on 31 December 2008.

The outstanding amounts of all government securities as at 31 December 2008 and 2009 are presented in **Table 4.5**.

Total government debt (excluding intergovernmental debt) increased to €9.016 million at the end of 2009 compared with €7.549,5 million at the end of 2008. The increase is mainly due to new borrowing through the Euro Medium Term Note (EMTN) Programme and Euro Commercial Paper (ECP).

The majority of the total government debt (excluding intergovernmental debt) is in GRDS. Excluding the intergovernmental debt and the special loan from the CBC, the outstanding amount of GRDS issues represented 43,5% of the total government

Table 4.5 Total amounts of investment instruments
(€ million)

As at	TBs	GRDS					SCs	EMTN	ECP	Total
		2-year	3-year	5-year	10-year	15-year				
31 Dec. 2008	6.637,3	59,8	145,3	1.781,7	1.321,8	204,5	87,0	1.050,0	476,4	11.763,8
31 Dec. 2009	7.384,7	0,0	86,3	1.612,3	1.214,9	204,5	66,2	2.550,0	625,6	13.744,5

Source: CBC.

debt as at 31 December 2009 compared with 59% at the end of 2008. Government borrowing through the EMTN programme represented 35,6% of the total debt. Other sources of government financing were the ECP with 8,7%, the European Investment Bank and the Council of Europe Development Bank with a total of 10,8%. At the end of 2009, 99,8% of the public debt was denominated in euro, while the remaining outstanding debt was denominated in yen, sterling, Swiss francs, Kuwait dinars and dollars.

The percentages of public debt with fixed and floating interest rates were 93,3% and 6,7%, respectively, compared with 85,7% and 14,3%, respectively, at the end of 2008.

At the end of 2009, the weighted average life and the weighted average interest rate of the public debt, excluding intergovernmental debt and the special loan from the CBC, were 5,5 years and 4,07%, respectively, compared with 6,6 years and 4,53%, respectively, at the end of 2008.

For the servicing of the public debt, principal repayments amounting to €1.954,3 million and interest payments (including those relating to ECP paper) amounting to €247,1 million were effected during 2009, as against €2.575,7 million and €324,9 million, respectively, during 2008.

On 3 June 2009, a Eurobond amounting to €1.500 million was placed with international institutional investors at an interest rate corresponding to 130 basis points above mid-

swaps. The eurobond has a four-year maturity and an annual coupon 3,75%. BNP Paribas, Societe Generale and the Royal Bank of Scotland plc were the lead managers of the issue. The co-managers group consisted of Alpha Bank A.E., Bank of Cyprus Public Co. Ltd and Marfin Popular Bank Public Co. Ltd. The largest foreign investors were primarily from Greece, Germany, the United Kingdom, Austria and Switzerland.

Reorganisation of government securities market

The CBC and the Ministry of Finance have, for some time now, identified the need for the reorganisation of the operational framework of the government bonds and bills market in Cyprus. The ultimate strategic objectives of this reorganisation is the lowering of the borrowing cost to the Republic of Cyprus through the creation of an efficient market with sufficient liquidity, especially following the adoption of the euro.

This reorganisation will include the: appointment of primary dealers; implementation of an electronic trading platform for the execution of the bonds and bills auctions in the primary market as well as for their trading in the secondary market; re-specification of the type and size of the instruments to be issued; and execution of bond repurchases/exchanges.

Preparatory work on the above planned reforms is well under way. The electronic

trading platform MTS has already been selected for the execution of the bonds and bills auctions in the primary market as well as for their trading in the secondary market. Following the decision of the Council of Ministers for the transfer of responsibility for the management of public debt from the CBC to the Ministry of Finance, the project for the reorganisation of the market is being handled and implemented exclusively by the Ministry of Finance.

4.8 Economic Research and Related Activities

The Economic Research Department (ERD) is responsible for analysing and monitoring both the domestic and euro area economies as well as the general international economic environment. This takes the form of detailed analysis of data and research, including the use of various econometric tools. The output from this work is partly reflected in the preparation and publication of the biannual *Economic Bulletin*. CBC staff systematically brief the Governor on all recent economic developments as well as the projections regarding the Cyprus and euro area economies. In particular, the Governor is provided with support for his preparation for the ECB Governing Council meetings in which he participates and contributes to the formation of the Eurosystem's monetary policy. ERD officials also participate in the ESCB Monetary Policy Committee and in its

working groups, supporting the work done at the Eurosystem level.

Other responsibilities include: the coordination of the visits by and participation in the presentations given to international organisations such as the IMF, the European Commission, the ECB and the three major ratings agencies; participation in the Economic and Financial Committee (EFC) of the EU and the subcommittee for IMF matters (SCIMF); presentations to various bodies regarding the CBC's activities such as colleges, schools, employers' organisations; and giving support to the Governor with press issues, IMF matters and issues relating to the Cyprus problem.

More analytically, during the year under review the June and December 2009 issues of the *Economic Bulletin* were published. The *Bulletin* concentrates on the main international and domestic economic developments, with particular emphasis on the analysis of inflation in Cyprus, monetary aggregates, developments in GDP and national accounts in general. The 2009 issues of the *Bulletin* included, for the second consecutive year, projections for the Cyprus economy using specialised statistical graphs (fan charts) depicting the potential risks of deviation from the main scenario. During 2009 five special analyses were included in the *Bulletin*, covering developments in the international financial architecture as a result of the crisis, domestic credit expansion, the

impact of the external economic environment on economic growth in Cyprus, a survey of wage and price formation of enterprises, as well as the sustainability of public finances in Cyprus. The *Bulletin* is first prepared in Greek and later in English, and can be found on the CBC website (www.centralbank.gov.cy).

For the purpose of preparing the Governor for the meetings of the ECB's Governing Council, monthly presentations to the Governor were prepared, analysing macroeconomic developments in the euro area and the world economy, with an emphasis on expectations for the future path of the economy.

CBC officials also participate in the Monetary Policy Committee of the ESCB and its working groups, dealing mainly with: (a) macroeconomic projections; (b) econometric modelling; and (c) public finances.

The Committee and its working groups keep track of economic and monetary developments in the euro area and the EU in general, and prepare reports supporting the decision-making process of the Governing Council.

Through its representatives in the Working Group on Forecasting, the CBC participates in the winter and summer projection rounds of the Eurosystem, publishing the national results in the *Bulletin*. These projections, which comprise *inter alia* the basic national GDP macroeconomic and, in cooperation with the Working Group on Public Finances, fiscal aggregates, are prepared by adopting

assumptions common to all euro area countries, making the euro area aggregate analysis feasible. In this framework, projections are prepared for the analytical national accounts, the labour market, balance of payments and public finances.

Inflation projections are carried out on a quarterly basis, two in the framework of the aforementioned macroeconomic projections of the Eurosystem and two during the spring and autumn staff exercises. Inflation projections include monthly projections for the HICP and its subcomponents of services, processed food, unprocessed food, energy and industrial products excluding energy. An estimation is also made for the effect on HICP of net indirect taxes and administratively-set prices.

In the framework of the CBC's participation in the Working Group on Econometric Modelling, an econometric model similar to the ECB's Multi-Country Model has been constructed for carrying out forecasts of basic sectors of the Cyprus economy. Apart from dealing with modelling issues, CBC staff support the Working Group on Forecasting on technical issues, such as analysing various scenarios, updating the projected model elasticities, answering questionnaires covering technical matters, etc.

Cyprus's obligations for the implementation of the Stability and Growth Pact, reflect the importance of fiscal policy. As a result of the CBC's participation in the

Working Group on Public Finances, the monitoring of fiscal developments has intensified with the aim of forming an independent opinion and autonomous projections as well as conducting various studies within the new environment.

Since 1 January 2008, the Bank Lending Survey, as part of a broader survey, is conducted on a quarterly basis at the Eurosystem level. The goal of this survey is the deeper understanding of the role of credit in the monetary policy transmission mechanism and the enrichment of the analysis for monetary policy purposes. The questionnaire is submitted to a sample of MFIs and its national results are, together with the aggregate euro area results, noted by the CBC.

In 2009 CBC staff participated in various task forces set-up with the purpose of studying specific issues relevant to the information available to the Governing Council. For example, its officials participated in the Household Finance and Consumption Network, the goal of which is the preparation and administration of a survey concerning the financial situation and consumption of households in the euro area. The first wave of the survey will be conducted during 2010, while intense preparations began during the year under review. Results from this survey can be used widely in studies for the better implementation of monetary policy.

The CBC also contributed to the Eurosystem's task force responsible for

studying the energy market in the euro area and which concluded with the preparation of a report to be submitted to the European Parliament in 2010. The main goal of this study was to find the pattern of fluctuations in energy prices and their effect on the medium-term goal of the ECB's monetary policy, which is the maintenance of price stability. Given the volatility of the international oil and gas markets, energy prices have been a challenge for the ECB's monetary policy. Consequently, the focus of the task force and the forthcoming report is to analyse the determining factors and the macroeconomic consequences of the fluctuations in energy prices on HICP and GDP. The results from the study are expected to aid the ECB during its monetary policy decision-making process, especially during periods of intense instability in energy prices.

Regarding other projects undertaken by the CBC, a survey was conducted in July 2009 in the context of the CBC's participation in the ECB task force for the analysis of wage dynamics. The survey focused on the process of and the factors affecting price and wage determination in domestic businesses. The findings of the survey were useful for certain aspects of the labour market and the business environment in Cyprus, and included the degree of coverage of employees by collective agreements and COLA. More detailed results of the survey can be found in the December 2009 issue of the *Economic*

Bulletin, which is also on the CBC website (www.centralbank.gov.cy). Further analysis of the data is being carried out, the results of which will be published on the CBC website during the first half of 2010. At the same time, ERD staff participated in the ECB working group responsible for analysing the relationship between the output gap and inflation projections.

In 2009 CBC staff continued with the project on the estimation of the real estate price index through the collection of valuations by Cypriot banks for real estate property and other relevant information. The annual real estate price index is estimated from 2002 and is published in the *Bulletin*. In addition, in 2009 the study for the enrichment of the existing analysis continued, with the purpose of collecting data from more banks and creating more indices. The aforementioned data collection will start at the beginning of 2010 with the aim of obtaining accurate information on the Cyprus real estate market.

CBC officials also participate in the Economic and Financial Committee (EFC) of the EU and the subcommittee for IMF matters (SCIMF). The EFC prepares the work of the Council of Finance Ministers of the EU (ECOFIN).

Furthermore, the CBC participated in the presentation and coordination of the visits in Cyprus by the three main credit rating agencies: Standard & Poor's, Moody's and

Fitch. These agencies assess the Cyprus economy at regular intervals and publish independent ratings. Fitch visited Cyprus in February 2009, Standard & Poor's in May 2009 and Moody's in September 2009. CBC staff also coordinated the IMF Article IV visit in June 2009 with other public and private sector bodies. It is also noted that the IMF visited Cyprus for a short review of the Cyprus economy in November 2009.

During 2009 regular contacts with journalists and news agencies were made, with the aim of briefing them on CBC related issues as well as exchanging views on the Cyprus economy. Moreover, CBC staff participated in the Governor's preparation for his public communication through articles, interviews and statements. The ERD had the responsibility for organising and coordinating two seminars. The first, titled International Seminar on Macroeconomics (ISOM), was held in June 2009, with leading academic economists as participants. The second was held in July 2009 and was a meeting of the Working Group on Public Finances.

During the year under review, the ERD participated in various internal workshops. The topics presented in these workshops are suggested by CBC staff according to their research and general interests and are related to their work at the CBC. Various research studies have been conducted by CBC staff and have appeared under the CBC's Working

Paper Series. Subjects include monetary policy and the euro and a comparison of two alternative methods of measuring unemployment in Cyprus. Finally, the CBC cooperates with other central banks and academic institutions in the field of research. In this context, its officials represented the CBC at various conferences and seminars both in Cyprus and abroad, where they presented the results of their research.

4.9 Statistics

During the year under review, the Statistics Department continued with the collection, processing, classification, validation, presentation and transmission of data and information relating to monetary, external, economic, government finance and other statistics to the ECB and other users in Cyprus and abroad.

At the same time, in order to achieve compliance with the requirements in terms of coverage, analysis and presentation of statistical information emanating from the relevant *acquis communautaire*, new data collection surveys, systems and practices were implemented. In addition, the quality of existing statistics was further enhanced.

On 1 December 2009, Cyprus became a subscriber to the IMF's Special Data Dissemination Standard (SDDS). To achieve the adoption of the SDDS, the CBC played a catalytic role and acted as the coordinator among the three institutions involved, i.e. the

CBC, the Ministry of Finance and Cystat. The CBC has been appointed as the official SDDS coordinator for Cyprus.

With the adoption of the SDDS, Cyprus is committed to transparency in the dissemination of statistics and the application of internationally recognised statistical standards, developments which are expected to enhance the credibility of the statistical data of Cyprus. It is worth noting that participation in the SDDS is on a voluntary basis and as at the end of 2009, 66 countries participate, including all EU member states.

Monetary and financial statistics

The year under review was marked by important developments in the area of monetary and financial statistics, the most important being the revision of five CBC directives, according to new statistical requirements of the ECB and the EU vis-à-vis MFIs. These relate to the monthly balance sheet, flows adjustments, interest rates, classification of institutional units as per the European system of accounts (ESA 95) and classification of loans based on economic activity in line with the NACE system. The revised directives are due for implementation in June 2010. Moreover, the improvement in the quality of the data produced and published continued to be among the CBC's main priorities during 2009.

The monthly publication Monetary and Financial Statistics has been significantly

revised and enriched with new tables showing, mainly, analyses of loans and deposits. Another innovation is the implementation of the ECB methodology for the calculation of annual growth rates, which takes into account monthly net flows/transactions instead of the monthly balances. The upgraded publication has received positive comments from both internal and external users of the above data.

Another important development has been the implementation of ECB Regulation 2007/8, concerning the submission of balance sheet, revaluation and reclassification data by investment funds, on a monthly basis. Investment funds submit their data files through an internet application, which are then checked and processed through the processing system developed internally at the CBC. The data are then transmitted to the ECB on an aggregated basis and, since December 2009, are published on the ECB website. In addition, the list of investment funds, which is updated on a quarterly basis, is compiled and transmitted to the ECB.

In parallel, the production and transmission of stock and flow data for the sector "Other financial intermediaries, except insurance corporations and pension funds" continued. Following the instructions of the ECB, the CBC has also commenced the transmission of stock and flow data for the sector "Insurance corporations and pension funds" on a quarterly basis.

During 2009 the monthly and quarterly transmission of MFI and CBC balance sheet and flows adjustments data to the ECB continued on a regular basis. At the same time, as part of the quality control of MFI statistical data, the CBC reassigned to the MFIs' internal/external auditors the duty to perform a special audit and file reports with the CBC on the quality of the monthly balance sheet, flows adjustments and interest rate data. The relevant reports were received during the last two months of 2009 and are under consideration. The conduct of a number of intensive data quality checks over the last two years has brought about substantial improvements, with beneficial effects for users.

The CBC continued the monthly submission to the ECB of statistics on interest rates applied by MFIs to deposits and loans, classified under the sectors of "Households", "Non-profit institutions serving households" and "Non-financial corporations", as well as their publication on the CBC website.

In addition to the projects mentioned above, the compilation and dissemination of securities statistics, covering issues of debt securities and shares, also continued. In this context, statistics concerning securities were disseminated to the ECB on a monthly basis. These data provide information regarding securities issued by Cypriot residents in all the sectors of the economy and in any currency.

The CBC's Money and Banking Statistics and Financial Accounts Section was also involved in several other tasks such as the production of structural statistical indicators, which are disseminated to the ECB and Eurostat through Cystat and the regular revision of the MFI list. Also, during 2009 the production and transmission of payment systems data to the ECB for the reference year 2008 was effected under the euro area reporting scheme.

Financial accounts

The CBC continued the transmission of quarterly financial accounts to the ECB. During the year under review, all derogations granted to Cyprus in accordance with Guideline ECB/2007/13 expired and the transmission of analytical who-to-whom data on short-term and long-term loans commenced. Quarterly financial accounts are compiled using mainly data derived from the statistical systems developed for collecting balance sheet data from the CBC, the MFIs and the investment funds. The balance of payments and international investment position data as well as the quarterly financial accounts of the general government, compiled by Cystat, are also used. In addition, the CBC conducts an annual survey for the collection of balance sheet data from pension and provident funds and processes the data available from the annual reports of insurance companies, investment firms, a sample of

NFCs as well as market data for the securities listed on the Cyprus Stock Exchange.

Balance of payments and international investment position

During the year under review, significant developments in the compilation of external statistics took place, with the main element being the design and implementation of two new surveys. The purpose of these surveys is, firstly, to improve data quality in the current account of the balance of payments and, secondly, to initiate the collection of more analytical data, according to the provisions of the pertinent Community legislation.

More specifically, the quarterly Survey on Insurance Companies was implemented successfully in February. The survey is addressed to companies resident in Cyprus and branches of non-resident companies registered/incorporated in the island, which provide non-life insurance/reinsurance services and/or life assurance/reinsurance services or insurance brokerage services.

The biannual Ship Management Survey was launched in March and is addressed to residents of Cyprus who provide ship management services to ship owning companies registered both in Cyprus and abroad.

In parallel, in implementing the provisions of Regulation EC 716/2007 on Community statistics with regard to the ownership structure and activities of foreign affiliates, the

CBC launched a new survey for the collection of annual information on foreign affiliates controlled by Cypriot ultimate parent entities/natural persons. The data collected was used for the compilation of outward foreign affiliate statistics in accordance with the methodology and level of analysis defined by the European Commission.

Furthermore, during the year under review, two new surveys were put into effect. These aim at the collection of data for the compilation of the current and financial account of the balance of payments, for entities which do not have a physical presence on the island (i.e. "brass plate").

The first survey, implemented in April, is addressed to ship owning companies which fall under the category of "brass plate" companies. The second survey is addressed to all "brass plate" entities excluding ship owning companies, and was sent to the reporting entities for completion in June.

The collection of the required data will be carried out on an annual basis and will include data on investment, income and expenditure of ship owning and other "brass plate" companies, in the context of their operations both in Cyprus and abroad.

Furthermore, the Balance of Payments Section dealt with the production of data for the balance of payments and the international investment position, including data regarding the transactions of "brass plate" companies for the whole 2008. The main source of

information for the production of the data was the banks (both domestic and former IBUs) operating from Cyprus.

During 2009 the CBC continued the monthly and quarterly production and transmission of the balance of payments statistics to the ECB as well as the quarterly and annual balance of payments statistics to Eurostat and the IMF. The monthly data for the international reserves template, in accordance with the IMF requirements as well as the international investment position of Cyprus concerning the financial assets and liabilities of residents, vis-à-vis non-residents of Cyprus, were also compiled.

In 2009 special attention was paid to the improvement of the data published on the CBC website. In particular, as from reference year 2008 the data produced are also published on the basis of the new definition of resident (i.e. including data on "brass plate" enterprises), which entered into force on 1 July 2008.

Government finance and general economic statistics

During the year under review, the timely transmission of reliable government finance and other economic statistics was particularly important due to the global financial crisis. The governments of all EU member states implemented a number of measures aimed at supporting the broad spectrum of financial institutions in their countries. Due to the heterogeneous

characteristics of these institutions and the continuous evolution and adaptation of the supportive measures, the likely impact on the fiscal deficit and public debt of each country is difficult to assess. Consequently, coordination at the EU level was necessary in order to achieve the desired and uniform statistical treatment.

In April and October 2009, the General Economic Statistics Section of the CBC carried out two government finance statistics (GFS) transmissions to the ECB, covering annual data for 2008 and revised annual data for the period 1995-2007. It is worth mentioning that the October transmission was based on the revised versions of the seven GFS tables which use the new ESA 95 methodology.

The 2009 transmissions include data relating to the general government, such as the impact of the flows from and to the EU, government consumption, the fiscal balance and its finance, debt according to the relevant Maastricht criterion as well as the total debt of the general government. During 2009 the CBC continued to submit to the ECB the quarterly Maastricht debt data, and in March and September 2009 the annual GFS data for the period 2005 – 2009 were transmitted to the ECB in the context of the excessive deficit procedure.

In addition, the CBC contributed to the preparation of the ECB Annual GFS Quality Report, which evaluates the quality of the annual GFS data submitted to the ECB by the euro area countries. The Report is submitted

to the ECB Governing Council and subsequently to the European Commission and the ECOFIN Council in compliance with Guideline ECB/2009/20.

Finally, the CBC continued to transmit to the ECB the required data related to general economic statistics. Within this framework, the CBC transmitted to the ECB, among other things: (i) the revised statement of the administratively set prices for Cyprus; (ii) information and data relating to the developments of prices for the housing sector; (iii) data in relation to the national indicator for the census of businesses; and (iv) the CPI, the Core CPI, the total number of unemployed, the unemployment rate and the number of job vacancies. The CBC also continued to transmit to the ECB the general economic statistics release calendar for the 18 predetermined indicators of general economic statistics.

On 1 December 2009, Cyprus adopted the SDDS, which identifies the following four dimensions of data dissemination: coverage, periodicity and timeliness of data; access to data by the public; integrity of the disseminated data; and quality of the disseminated data. By subscribing to the SDDS, Cyprus has undertaken a commitment to observe the requirements of this Standard and to inform the IMF and the users about its methodologies and practices in collecting and disseminating to the public economic and financial data. This information is

accessible through the IMF's Dissemination Standard Bulletin Board (DSBB).

The data will be available to the public on specified dates, based on an advance release calendar, to be announced, and will cover the following sectors of the Cypriot economy: real sector, fiscal sector, financial sector, external sector and socio-demographic data (population). Interested users can obtain access to the above data through the CBC website (www.centralbank.gov.cy).

4.10 Information Technology

The main priorities of the Information Technology Department in 2009 were dictated by the international financial crisis, the development of new information systems relating to Eurosystem processes and the upgrading of existing ones due to Eurosystem requirements. Moreover, the level of security, availability and efficiency of the CBC's information technology environment were assessed and enhanced as part of a continuous and regular process.

At the same time, the CBC participated in the ESCB's Information Technology Committee and its working groups, and proceeded with the timely implementation of ESCB projects and decisions.

IT project portfolio management

During 2009 the management of the IT projects portfolio was fully implemented through the procedure for the submission,

assessment, prioritisation and progress control of the following projects.

Infrastructure projects

The infrastructure of the databases was upgraded and enhanced. The enhancement was deemed necessary due to the ever increasing data volumes of statistical applications as well as the demand for new applications.

The ESCB Net infrastructure was also upgraded and the CoreNet 2 project was completed, enabling the direct connection with all ESCB central banks, including the ECB, with increased bandwidth.

Two other projects under development are: (a) the materialisation of the new internet architecture and the ESCB-Net infrastructure, which will enhance the level of security and performance and will enable the use of more and upgraded internet services; and (b) the link of the Central Information Registry for Dishonoured Cheques to the Artemis system, which will enable the exchange of data regarding the financial credibility of physical and legal persons between banks.

Office automation projects

The infrastructure for back-up arrangements for the office automation environment was upgraded in order to meet the demands of new needs and to improve the security level and administration of this infrastructure.

The granting of access to the document

management system of the ECB to the users of the CBC was also completed. This allows users to search, record and modify documents easily and securely. Moreover, a major part of the user technology, which includes printers, personal and portable computers, was replaced.

IT systems implementation/maintenance projects

The following projects have been completed:

- The automation of the collection and processing of data from investment funds and the automatic creation of reports to be submitted to the ECB.
- The development of an automated Government Collateral Management System in connection with the special government bonds, which were issued in order to reinforce the liquidity position of banks with the aim of decreasing interest rates.
- The first phase of the SEPA (Single Euro Payments Area) project, which enables payments in euro by banks to be executed in accordance to the directives of the European Committee and the ECB.
- The connection of the CashSSP system to the internal information systems of the CBC enabling the automation of related processes.
- The adoption of the latest versions of the Oracle tools for improved functionality and availability of the statistical systems.
- The extension of the accessibility to the

Central Information Registry for Dishonoured Cheques to organisations outside the banking sector.

- The adoption of the IMF's Special Data Dissemination Standard as regards the provision of statistical data, which defines a series of parameters regarding the way in which the basic economic data of a country are communicated. Statistical data regarding Cyprus are published on the IMF web page in accordance with this standard.
- The connection to the Euroclear Single Platform Custody which enables the management of securities and the settlement of their transactions with improved efficiency.

At the same time, new questionnaires were introduced within the Direct Reporting System to collect additional information related to the balance of payments. Furthermore, the payroll system was adapted in order to comply with the new agreement with the bank employees union, ETYK.

Within the context of systems maintenance, numerous modifications were made to the statistical systems in order to meet the demands of the Eurosystem, as well as to other systems, such as the Collateral Management System and the Open Market Operations System, which were deemed necessary due to the international financial crisis.

The following projects are under

development and are expected to be completed in 2010:

- The implementation of the new Human Resource Management System and its interfacing with the CBC's internal systems, which will be effected in phases.
- The Electronic Cheque Truncation system.
- The system for data collection and generation of financial stability indicators, for monitoring the banking sector and producing reports for submission to the ECB and the IMF.

IT systems security

The security of the CBC's information technology environment was regularly assessed and enhanced, mainly through the aforementioned projects and through external security assessments. Moreover, criticality assessments were conducted for new systems with regard to confidentiality, integrity and availability of information held by these systems and security measures were applied accordingly.

4.11 Human Resources, Organisation and Methods

During 2009 the CBC intensified its efforts to enhance the existing human resources processes and procedures and to introduce new best practices.

Human Resources

The Human Resources, Organisation and

Methods (HR, O&M) Department, with the active involvement of the IT Department, initiated the human resources automation project aiming to introduce an integrated software package. The project is expected to be completed in three phases over a two-year period, with the first phase expected to be completed in early 2010. The new automated system will lead to greater organisational efficiency and improve the overall performance in human resources management. Furthermore, it will assist the CBC's management in their decision making process and the establishment of new human resources related policies.

The CBC adopted a new procedure with respect to staff mobility / internal transfers, in order to give the opportunity to members of staff to gain more experience and develop their skills. Furthermore, the benefits from staff mobility are expected to be significant, as departments will gain from the previous experience of staff, and line managers will have the opportunity to be actively involved in the selection of their staff.

The collective negotiation process was completed and resulted in the renewal of the collective agreement between the Cyprus Union of Bank Employees (ETYK, Greek acronym) and the CBC. The collective agreement covers the period 2008-2010.

During 2009 the CBC recruited additional staff in the areas of economics, accounting and information technology. The recruitment

of economists was completed during the year under review whereas the remaining vacancies are expected to be filled within 2010. Furthermore, the CBC proceeded with promotions to the posts of directors, assistant directors and senior officers.

In the area of human resources development, the CBC organised seminars for information technology programmes such as Microsoft Office (Word, Excel, Power Point, etc.) with the help of local independent training providers.

During 2009 support was provided to those CBC departments that hosted ESCB committee and working group meetings in Cyprus. Furthermore, public procurements were carried out for the provision of cleaning services for the CBC's building, insurance cover and consultancy services for health and safety risk assessment and the development of a new health and safety system.

Organisation and Methods

The Organisation and Methods Section continued to provide support to the CBC's departments for the redesign of internal procedures, and maintained the smooth operation of the new internal correspondence system, the messengers team and the CBC archives. In addition, it undertook the organisation and coordination of the operational risk management project, adopting a framework developed at the Eurosystem level, and coordinated the collection of data

from the CBC's departments for the purpose of Eurosystem studies and surveys.

The CBC website and intranet portal were systematically monitored and support was provided to the departments responsible for maintaining the content.

Finally, throughout the year members of the HR,O&M Department participated in Eurosystem and ESCB committees and working groups according to their areas of responsibility.

4.12 Premises and Security

The Security and Technical Services Department is responsible for maintaining the building installations of the CBC in good working order. It contributes to the smooth operation of the CBC by ensuring that the office environment is safe, pleasant and conducive to productive work.

During the year under review, the main priorities were the application of strict security measures for the protection of the building and its installations as well as the upgrading of the existing security system. The training of the security staff continued and the security arrangements were improved. Also, during 2009 departmental staff participated in the ESCB's Security Working Group and Heads of Administration conference. As part of the CBC's contribution to renewable energy, plans were made so that a photovoltaic system will be installed in 2010. Furthermore, the telephone and building

management systems were upgraded. Staff were trained in the implementation of the regulations for electrical installations, electrical generators and protection measures as well as in issues related to health and safety. There was continuous monitoring and control of the building's environmental conditions and the operation of equipment. Finally, the mechanical equipment for the reduction of energy consumption was upgraded.

Currently under consideration are: the replacement of the old air conditioning system water chillers with chillers incorporating the latest technology in order to reduce energy consumption; the upgrading of one of the elevators; and the uninterruptable power supply (UPS) of the information technology systems.



CENTRAL BANK OF CYPRUS
EYROSYSTEM

5. FINANCIAL STATEMENTS
2009

Central Bank of Cyprus
Eurosystem

BALANCE SHEET AS AT 31 DECEMBER 2009

ASSETS	31-Dec-2009 €'000	31-Dec-2008 €'000
1 Gold and gold receivables	342.372	277.685
2 Claims on non-euro area residents denominated in foreign currency	540.850	427.898
2.1 Receivables from the IMF	160.806	29.414
2.2 Balances with banks and security investments, external loans and other external assets	380.044	398.484
3 Claims on euro area residents denominated in foreign currency	522.446	771.363
4 Claims on euro area residents denominated in euro	0	68.500
4.1 Balances with banks, security investments and loans	0	68.500
4.2 Claims arising from the credit facility under ERM II	0	0
5 Lending to euro area credit institutions denominated in euro related to monetary policy operations	7.559.400	4.370.000
5.1 Main refinancing operations	30.000	1.490.000
5.2 Longer-term refinancing operations	7.529.400	2.880.000
5.3 Fine-tuning reverse operations	0	0
5.4 Structural reverse operations	0	0
5.5 Marginal lending facility	0	0
5.6 Credits related to margin calls	0	0
6 Other claims on euro area credit institutions denominated in euro	1.297	84.614
7 Securities of euro area residents denominated in euro	2.473.386	2.446.054
7.1 Securities of euro area residents denominated in euro held for monetary policy purposes	51.099	0
7.2 Other securities of euro area residents denominated in euro	2.422.287	2.446.054
8 General government debt denominated in euro	1.550.664	1.597.054
9 Intra-Eurosystem claims	259.871	203.295
9.1 Participating interest in ECB	26.674	23.076
9.2 Claims equivalent to the transfer of foreign reserves	78.863	71.951
9.3 Claims related to promissory notes backing the issuance of ECB debt certificates	0	0
9.4 Net claims related to the allocation of euro banknotes within the Eurosystem	154.334	108.268
9.5 Other claims within the Eurosystem (net)	0	0
10 Items in course of settlement	39.932	66.396
11 Other assets	168.000	378.211
11.1 Coins of euro area	0	0
11.2 Tangible and intangible fixed assets	13.202	14.545
11.3 Other financial assets	0	0
11.4 Off-balance sheet instruments revaluation differences	9.375	46.064
11.5 Accruals and prepaid expenses	88.970	107.575
11.6 Sundry	56.453	210.027
Total Assets	13.458.218	10.691.070

The notes on pages 73-92 form part of these accounts

Central Bank of Cyprus
Eurosystem

BALANCE SHEET AS AT 31 DECEMBER 2009

LIABILITIES	31-Dec-2009 €'000	31-Dec-2008 €'000
1 Banknotes in circulation	1.455.572	1.340.759
2 Liabilities to euro area credit institutions related to monetary policy operations	3.100.987	1.292.228
2.1 Current accounts (covering the minimum reserve system)	1.237.204	1.291.508
2.2 Deposit facility	1.863.783	720
2.3 Fixed-term deposits	0	0
2.4 Fine-tuning reverse operations	0	0
2.5 Deposits related to margin calls	0	0
3 Other liabilities to euro area credit institutions denominated in euro	0	0
4 Debt certificates issued	0	0
5 Liabilities to other euro area residents denominated in euro	452.908	457.930
5.1 General government	444.549	447.501
5.2 Other liabilities	8.359	10.429
6 Liabilities to other non-euro area residents denominated in euro	115.007	107.141
7 Liabilities to euro area residents denominated in foreign currency	190	234
8 Liabilities to non-euro area residents denominated in foreign currency	44.158	0
8.1 Deposits, balances and other liabilities	44.158	0
8.2 Liabilities arising from the credit facility under ERM II	0	0
9 Counterpart of special drawing rights allocated by the IMF	144.571	21.475
10 Intra Eurosystem liabilities	7.127.899	6.551.231
10.1 Liabilities equivalent to the transfer of foreign reserves	0	0
10.2 Liabilities related to promissory notes backing the issuance of ECB debt certificates	0	0
10.3 Net liabilities related to the allocation of euro banknotes within the Eurosystem	0	0
10.4 Other liabilities within the Eurosystem (net)	7.127.899	6.551.231
11 Items in course of settlement	45.734	72.168
12 Other liabilities	240.828	290.805
12.1 Off-balance sheet instruments revaluation differences	11.138	47.665
12.2 Accruals and income collected in advance	6.304	30.657
12.3 Sundry	223.386	212.483
13 Provisions	181.757	160.264
14 Revaluation accounts	369.537	325.947
15 Capital and Reserves	63.623	61.807
15.1 Capital	30.000	30.000
15.2 Reserves	33.623	31.807
16 Surplus for the year	115.447	9.081
Total Liabilities	13.458.218	10.691.070

The notes on pages 73-92 form part of these accounts

Central Bank of Cyprus
Eurosystem

INCOME AND EXPENDITURE ACCOUNT
for the period 1 Jan. 2009 - 31 Dec. 2009

	2009		2008	
	€'000	€'000	€'000	€'000
1.1 Interest income	264.823		250.772	
1.2 Interest expense	(136.230)		(184.161)	
1 Net interest income		128.593		66.611
2.1 Realised gains arising from financial operations	12.825		1.618	
2.2 Writedowns on financial assets and positions	(1.265)		(6.917)	
2.3 Transfer to provisions for foreign exchange and price risks	(14.516)		-	
2 Net result of financial operations, writedowns and risk provisions		(2.956)		(5.299)
3.1 Fees and commissions income	1.586		1.684	
3.2 Fees and commissions expense	(146)		(127)	
3 Net income from fees and commissions		1.440		1.557
4 Income from equity shares and participating interests		4.420		2.369
5 Net result of pooling and redistribution of monetary income		(7.275)		(21.490)
6 Other income		36.633		4.218
Total Net Income		160.855		47.966
7 Staff costs	(38.671)		(31.746)	
8 Administrative expenses	(4.413)		(4.798)	
9 Depreciation of tangible fixed assets	(1.924)		(1.960)	
10 Banknote acquisition cost	-		(141)	
11 Other expenses	(400)		(240)	
Total Expenses		(45.408)		(38.885)
Surplus for the year		115.447		9.081
Appropriation Account				
General Reserve		23.089		1.816
Consolidated Fund of the Republic		92.358		7.265
Surplus for the year		115.447		9.081

15 March 2010

Dr Athanasios Orphanides
Governor

The notes on pages 73-92 form part of these accounts

5. Notes to the Financial Statements

Accounting Policies

General principles for the preparation of the financial statements

As from 1 January 2008, the financial statements of the CBC are prepared in accordance with article 57(2) of the *Central Bank of Cyprus Law, 2002-2007*. The said article conforms with the accounting principles applicable in the ESCB, as determined by Accounting Guideline ECB/2006/16 (amended by guidelines ECB/2007/20, ECB/2008/21, ECB/2009/18 and ECB/2009/28).

These principles, even though based on generally accepted accounting principles, have been designed to take account of the specialised operational framework of the national central banks (NCBs) of the Eurosystem.

Main accounting principles

The main accounting principles applicable in the Eurosystem and applied by the CBC are:

- *The principle of economic reality and transparency* in the presentation of the financial assets and liabilities of the CBC so as to present its true financial position.
- *The principle of prudence*. In accordance with this principle, unrealised gains from the revaluation of gold, financial instruments in foreign currency and securities are not recognised as income in the profit and loss account but are transferred directly to revaluation accounts. On the other hand, unre-

alised losses resulting from revaluations at the end of the accounting period and exceeding unrealised profits previously transferred to the revaluation accounts are recognised as expenses and transferred to the profit and loss account.

- *The principle of the recognition of post-balance sheet events*, i.e. events that have occurred between the balance sheet date and the date of the approval of the accounts. If such events have a material influence on the financial position of the CBC the assets and liabilities are adjusted accordingly.
- *The principle of materiality*.
- *The principle of going concern*. The financial statements have been prepared on a going concern basis.
- *The principle of accruals*. Income and expenses are recognised in the year in which they occur irrespective of when they are collected or paid.
- *The principle of consistency and comparability*. The criteria for the valuation of the balance sheet items and the construction of the income and expenditure account are applied with consistency so as to ensure the comparability of items in the financial statements.

Recognition of assets and liabilities

An asset or liability is recognised in the balance sheet only when it is probable that

any associated future economic benefit will flow to or from the CBC, all of the associated risks and rewards have been substantially transferred to the CBC, and the cost or value of the asset or the amount of the obligation can be measured reliably.

Accounting treatment of transactions

On the basis of Accounting Guideline ECB/2006/16, foreign currency transactions, financial instruments denominated in foreign currency and related accruals are recorded at spot settlement date (economic 'alternative' approach). Interest accrued on foreign fixed deposits and financial instruments, including premiums or discounts, is recorded on a daily basis from the spot settlement date.

At year-end, both financial assets and liabilities are revalued at current market prices/rates. This applies both to on-balance sheet and off-balance sheet transactions.

The average acquisition cost and the value of each currency position are calculated on the basis of the sum total of the holdings in any one currency, including both asset and liability positions and both on-balance sheet and off-balance sheet items.

Balance sheet valuation rules

The assets and liabilities of the CBC in foreign currency and gold are valued on the basis of the ruling exchange rates on the date of the balance sheet as these appear on the currency exchange rates report of the ECB.

Income and expenses are translated into euro using the exchange rates ruling at the time of the transaction.

As regards gold there is no distinction between the differences resulting from price adjustments and exchange revaluations. A single gold valuation is accounted for based on the price of gold in euro per fine ounce, as this is determined from the exchange rate of the euro against the US dollar at the date of the balance sheet.

The readjustment of the value of assets and liabilities in foreign currency is carried out on a currency by currency basis, including both on-and off-balance sheet items.

Income recognition

Gains and losses realised in the course of transactions in foreign currency and securities are taken to the profit and loss account. The average cost method is used on a daily basis for gold, foreign currency instruments and securities to compute the acquisition cost of items sold, having regard to the effect of exchange rate and/or price movements.

Unrealised revaluation gains arising from the revaluation of a security or currency or holdings in gold are not taken to the profit and loss account, but transferred directly to revaluation accounts on the balance sheet. Unrealised losses are recognised in the income and expenditure account when they exceed previous revaluation gains registered in the

corresponding revaluation account; they may not be reversed against new unrealised gains in subsequent years.

Premiums or discounts arising on securities are calculated and presented as part of interest income and are amortised over the remaining life of the securities.

Fixed assets

Fixed assets are valued at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis from the year of acquisition and for the expected economic life of the assets:

Asset category	Depreciation Period
Computers, related hardware and software, motor vehicles	4 years
Equipment, furniture and plant in building	10 years
Buildings	25 years
Fixed assets purchased for less than €10.000	No capitalisation

Retirement plan

The CBC operates a defined benefit scheme for its staff. The liability recognised in the balance sheet in respect of the defined benefit plan is the present value of the defined benefit obligation at the balance sheet date. The defined benefit obligation is calculated annually using the projected unit credit method. The present value of the

defined benefit obligation is determined by discounting the estimated future cash flows, using interest rates of high quality corporate bonds that are denominated in euro and have similar terms of maturity to the term of the related pension liability. Actuarial gains and losses can arise from adjustments (where actual outcomes are different from the actuarial assumptions) and changes in actuarial assumptions. The net amount recognised in the income and expenditure account comprises the current service cost of the benefits accruing for the year, the interest at the discount rate on the defined benefit obligation and the past services cost.

ESCB capital key

The capital key is essentially a measure of the relative size of each EU member state and is calculated, in equal shares, on the basis of GDP and population size. The key is used as the basis for allocating each NCB's share in the ECB capital and is adjusted every five years and every time a new member joins the EU.

The Eurosystem key is the adjusted capital key for Eurosystem NCBs only and is used as the basis for the allocation of monetary income, banknotes in circulation and the ECB's profit/loss.

Securities held for monetary policy purposes

Following the decisions of the Governing Council of 7 May and 4 June 2009, the ECB

and the NCBs started to purchase euro-denominated covered bonds issued in the euro area for monetary policy purposes. These bonds are valued at amortised cost and are subject to impairment tests.

Securities held for purposes other than monetary policy

Marketable securities other than those held-to-maturity and similar assets are valued at the mid-market prices prevailing at the balance sheet date, on a security-by-security basis (by ISIN). Marketable securities classified as held-to-maturity and non-marketable securities are valued at amortised cost and are subject to impairment tests.

Banknotes in circulation

Euro banknotes are issued by the ECB and the NCBs, which together comprise the Eurosystem. The total value of banknotes in circulation is allocated among the ECB and the Eurosystem NCBs on the last working day of each month. The ECB is allocated a share of 8% of the total value of euro banknotes in circulation, whereas the remaining 92% is allocated to the Eurosystem NCBs according to their banknote allocation key. The share of banknotes allocated to the CBC is disclosed under the balance sheet liability item "banknotes in circulation".

The difference between the value of the euro banknotes allocated to each NCB in accordance with the banknote allocation key

and the value of the euro banknotes that it actually puts in circulation, gives rise to remunerated intra-Eurosystem balances. These claims or liabilities are disclosed under the sub-items "intra-Eurosystem claims/intra-Eurosystem liabilities: net claims/liabilities related to the allocation of euro banknotes within the Eurosystem".

In the first five years following the year of the cash changeover and the introduction of the euro in any member state, the intra-Eurosystem balances arising from the allocation of euro banknotes are adjusted in order to avoid significant changes in the respective NCB's relative income positions as compared with previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation for each NCB in the reference period and the average value of banknotes that would have been allocated to each NCB during the same period applying the banknote allocation key. This adjustment is phased out annually until the first day of the sixth year following the year of the cash changeover when income on banknotes is allocated fully in proportion to the paid-up share of each NCB in the capital of the ECB. For the CBC the adjustment period ends on 31 December 2013.

The interest income or expense on these balances is cleared through the accounts of the ECB and is disclosed under item 1 ("Net interest income") of the income and expenditure account.

The Governing Council of the ECB has

decided that the seigniorage income of the ECB arising from the 8% share of euro banknotes allocated to the ECB shall be due to the NCBs in the same financial year it accrues, and distributed on the second working day of the following year in the form of an interim distribution of profit. This shall be distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation, and subject to any decision by the Governing Council to reduce this income in respect of costs incurred by the ECB in connection with the issue and handling of euro banknotes.

The Governing Council may also decide to transfer part or all of the ECB's seigniorage income to the provision for foreign exchange rate, interest rate and gold price risks. Any amounts distributed to the CBC are recognised in the profit and loss account under item 4, "Income from equity shares and participating interests".

Intra-Eurosystem balances

Intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are included in the balance sheet under "Claims related to the allocation of euro banknotes within the Eurosystem".

Post-balance sheet events

Assets and liabilities are adjusted so as to take account of events occurring between the balance sheet date and the date the

financial statements are approved by the Board of Directors, provided such events have a significant impact on the state of these assets and liabilities as at the balance sheet date. Significant events occurring after the balance sheet date that do not affect the state of assets and liabilities as at the balance sheet date appear in the notes.

BALANCE SHEET

ASSETS

1. Gold and gold receivables

This item comprises the CBC's holdings of international specifications gold, which on 31 December 2009 amounted to 446.794,79 fine ounces the same as at 31 December 2008. With a market value of €766,4 per fine ounce (31 December 2008: €621,5), the CBC's gold holdings were valued at €342,4 million at the balance sheet date (31 December 2008: €277,7 million). These gold holdings are kept with foreign central banks.

The valuation of gold is carried out on the basis of the price in euro per fine ounce in force at the end of the year as this is reported in the ECB special report on exchange rates. The price in euro per fine ounce is derived on the basis of the price of gold in US dollars combined with the euro / dollar exchange rate as at the same date. The revaluation on 31 December 2009 resulted in an unrealised valuation gain of €64,7 million (31 December 2008: €23,8 million) and these are shown in the balance sheet under liability item 14.

Table 1 **Receivables in SDR from the IMF**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Quota in IMF (equivalent to SDR139,6 million)	151.970	154.230	(2.260)
IMF deposits	(121.107)	(126.780)	5.673
Reserve position with the IMF	30.863	27.450	3.413
SDR holdings	129.943	1.964	127.979
Total claims on the IMF	160.806	29.414	131.392

Table 2 **Claims denominated in foreign currency**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Balances with overseas credit institutions	123.487	50.649	72.838
Marketable securities other than held to maturity	256.387	347.649	(91.262)
Other external assets	170	186	(16)
Total	380.044	398.484	(18.440)

2. Claims on non-euro area residents denominated in foreign currency

These claims consist of receivables in special drawing rights (SDRs) from the IMF and claims denominated in foreign currency against non-euro area countries.

2.1 Receivables in SDR from the IMF

(Table 1)

The SDR holdings increased following the IMF's Board of Governors' resolutions on 7 and 10 August 2009 for an increase in the holdings of its member countries.

The above claims on the IMF were valued with the prevailing SDR rate at 31 December

2009, as reported by the ECB in its exchange rates circular, i.e. SDR1 = €1,0886 (31 December 2008: SDR1 = €1,1048).

2.2 Claims denominated in foreign currency

(Table 2)

3. Claims on euro area residents denominated in foreign currency

(Table 3, p. 79)

Table 3 **Claims on euro area residents denominated in foreign currency**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Balances with overseas credit institutions	244.892	414.287	(169.395)
Marketable securities other than held to maturity	277.554	357.076	(79.522)
Total	522.446	771.363	(248.917)

Table 4 **Claims on non-euro area residents denominated in euro**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Balances with credit institutions	0	68.500	(68.500)
Securities	0	0	0
Total	0	68.500	(68.500)

Table 5 **Lending to euro area credit institutions related to monetary policy operations denominated in euro**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
5.1 Main refinancing operations	30.000	1.490.000	(1.460.000)
5.2 Longer-term refinancing operations	7.529.400	2.880.000	4.649.400
Total	7.559.400	4.370.000	3.189.400

4. Claims on non-euro area residents denominated in euro

This item comprises deposits in euro with credit institutions outside the euro area (**Table 4**).

5. Lending to euro area credit institutions related to monetary policy operations denominated in euro

This item reflects the volume and composi-

tion of amounts related to the participation of credit institutions located and operating in Cyprus, in the liquidity providing Eurosystem monetary policy operations executed in a decentralised manner by the NCBs of the euro area member states (**Table 5**).

Table 6 **Securities held for monetary policy purposes**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Covered bonds	51.099	0	51.099

5.1 Main refinancing operations

These are regular liquidity providing open market operations executed by the Eurosystem in the form of a reverse transaction. They are conducted through weekly standard tenders and normally have a maturity of one week.

5.2 Longer-term refinancing operations

These are regular liquidity providing open market operations executed by the Eurosystem in the form of a reverse transaction. They are conducted through monthly standard tenders. They normally have a maturity of three months and aim to provide the credit system with additional longer-term refinancing. The balance also includes the supplementary longer-term refinancing operations (LTRO) of 1, 3, 6 and 12-months maturity which were carried out in the context of the measures to combat the financial crisis.

6. Other claims on euro area credit institutions denominated in euro

This item comprises mainly of term deposits of the CBC in euro with correspondents in the

euro area and other claims not related to monetary policy operations.

7. Euro area securities denominated in euro

In order to report securities held for monetary policy purpose separately, the item "Securities of euro area residents denominated in euro", has been divided into two sub-items: "Securities held for monetary policy purposes", which reflects the euro-denominated covered bonds portfolio, issued in July 2009; and "Other securities", which includes marketable and non-marketable securities that are not related to the monetary policy operations of the Eurosystem.

7.1 Securities held for monetary policy purposes (Table 6)

This item comprises securities acquired by the CBC in the context of the programme for the purchase of covered bonds announced by the Governing Council of the ECB on 7 May 2009 (see "Securities held for monetary policy purposes" on p. 75).

7.2 Other securities of euro area residents denominated in euro (Table 7, p. 81)

Marketable securities held to maturity are

Table 7 **Other securities of euro area residents denominated in euro**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Marketable securities other than held to maturity	1.336.651	1.399.258	(62.607)
Marketable securities classified as held to maturity	1.085.636	1.046.796	38.840
Total	2.422.287	2.446.054	(23.767)

securities with fixed or determinable payments and a fixed maturity which the CBC intends to hold until maturity.

8. General government debt denominated in euro

This balance sheet item exclusively represents the claim that the CBC has on the Cyprus government for a long-term loan issued prior to Cyprus's accession to the EU. According to the official agreement between the CBC and the Ministry of Finance, the loan is for an initial term of 30 years, starting from 4 July 2002, with a grace period of five years as regards capital repayment and bears interest at 3% per annum.

In 2009 capital repayments amounted to €46,4 million (2008: €45 million) while interest payments amounted to €47,9 million (2008: €49,3 million).

9. Intra-Eurosystem claims

9.1 Participating interest in the capital of the ECB

This item shows the CBC's participating interest in the ECB. Under article 28 of the ESCB Statute, the NCBs of the ESCB are the

sole subscribers to the capital of the ECB. Subscriptions depend on the capital key of each NCB which is calculated on an equal basis on the proportion of each member state in the GDP of the EU, and on its share in the EU's total population (article 29.1 of the ESCB Statute).

The NCBs outside the euro area are called upon to contribute only 7% of their capital key allotment in the capital of the ECB. When the Republic of Cyprus joined EMU on 1 January 2008, the CBC contributed the remaining 93% of its allotted share in the ECB capital raising the contributed amount to €7,2 million. At the same time it contributed, in accordance with its capital key, to the reserves and provisions of the ECB raising its contribution in the general capital of the ECB to €15,9 million.

On 1 January 2009, the allocated capital key of the CBC changed from 0,1249% to 0,1369% due to the quinquennial capital key adjustment. As a result, the amount subscribed by the CBC to the ECB's issued capital increased to €7,9 million while its

Table 8 **Fixed assets**

	Land & building €'000	Furniture & equipment €'000	Computer software & hardware €'000	Motor vehicles €'000	Total €'000
Cost					
as at 01/01/2009	22.156	11.654	5.625	938	40.373
Additions	54	237	290	0	581
Disposals	0	(33)	0	(46)	(79)
As at 31/12/2009	22.210	11.858	5.915	892	40.875
Accumulated depreciation					
As at 01/01/2009	11.511	8.261	5.292	764	25.828
Charge	800	595	355	174	1.924
Disposals	0	(33)	0	(46)	(79)
As at 31/12/2009	12.311	8.823	5.647	892	27.673
Net book value					
As at 31/12/2009	9.899	3.035	268	0	13.202
As at 01/01/2009	10.645	3.393	333	174	14.545

participation to the general capital of the ECB increased to €18,8 million.

9.2 Claims equivalent to the transfer of foreign reserves

This item represents the CBC's claims arising from the transfer of foreign reserve assets to the ECB in accordance with the provisions of the Treaty establishing the European Community (article 30 of ESCB Statute).

The value of foreign reserves transferred was in proportion to the CBC's participation in the paid up capital of the ECB and was made up of 85% in US dollars and 15% in gold. These claims are denominated in euro at the original conversion rate. They are remunerated at the latest available marginal rate for the Eurosystem's main

refinancing operations, adjusted to reflect a zero return on the gold component.

The adjustments of the capital key weightings of the ECB on 1 January 2009 resulted in the adjustment of the claim of the CBC with respect to the foreign reserve assets transferred to the ECB. In order to reflect its increased capital key share, the euro-denominated claim of the CBC increased from €72 million to €78,9 million.

9.4 Net claims related to the allocation of euro banknotes within the Eurosystem

This item comprises of the claims and liabilities of the CBC vis-à-vis the Eurosystem relating to the allocation of euro banknotes within the Eurosystem (see "Banknotes in circulation", p. 76 and "Intra-Eurosystem balances", p. 77).

Table 9 **Banknotes in circulation**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Euro banknotes	1.455.572	1.258.579	196.993
Banknotes denominated in Cyprus pounds	0	82.180	(82.180)
Total	1.455.572	1.340.759	114.813

Table 10 **Liabilities to euro area credit institutions related to monetary policy operations denominated in euro**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
2.1 Current accounts (covering the minimum reserve system)	1.237.204	1.291.508	(54.304)
2.2 Deposit facility	1.863.783	720	1.863.063
Total	3.100.987	1.292.228	1.808.759

10. Items in the course of settlement

This claim mainly results from the process of the Cyprus Clearing House for cheques.

11. Other assets

11.2 Fixed assets (Table 8, p. 82)

11.3 Other financial assets

There are no participating interests in subsidiaries or investments held as an earmarked portfolio.

11.4 Off-balance sheet instruments' revaluation differences

This item reflects the valuation of contracts for the exchange of currencies on the basis of the exchange rates ruling at the end of the year.

LIABILITIES

1. Banknotes in circulation (Table 9)

This item comprises of the CBC's share of the total euro banknotes in circulation as calculated on the basis of its banknotes distribution key (see "Banknotes in circulation", p. 76).

The total value of banknotes denominated in Cyprus pounds which ceased to be legal tender with the introduction of the euro and had not, until 31 December 2009, been returned to be exchanged with euro banknotes was €74,6 million. This is included under item 12 of the balance sheet, "Other liabilities". The respective figure as at 31 December 2008 was €82,2 million.

2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro (Table 10, p. 83)

2.1 Current accounts (covering the minimum reserve system)

This item contains the credit institutions' current accounts which are required to be held with the CBC within the framework of the Eurosystem's minimum reserve system.

2.2 Deposit facility

This is a standing facility of the Eurosystem which counterparties may use to make overnight deposits in a national central bank, which are remunerated at a pre-specified interest rate.

5. Liabilities to euro area residents denominated in euro

This item refers mainly to the deposits held by the government and other public sector counterparties.

6. Liabilities to non-euro area residents denominated in euro

This item is comprised mainly of euro-denominated liabilities to the European Commission for refinancing projects in Cyprus.

7. Liabilities to euro area residents denominated in foreign currency

These are deposits in foreign currency by public sector organisations other than government. Balances as at 1 January 2008

also include commercial bank accounts which, however, were closed in 2008.

9. Counterpart of special drawing rights allocated by the IMF

This item represents the counterpart in euro of the SDR132,8 million allocated to the CBC as a result of Cyprus's membership of the IMF (31 December 2008: SDR19,4 million).

10. Intra-Eurosystem liabilities

This item is primarily made up of the net TARGET2 balance, arising from cross-border transfers via TARGET2 with other national central banks in the euro area, the ECB and other national central banks of the ESCB that participate in TARGET2.

These obligations arise, on the one hand, from the transfer of the excess liquidity of the local credit institutions to other EU member states following the adoption of the euro on 1 January 2008 and, on the other hand, from the funding of credit institutions operating in Cyprus within the context of the exercise of a unified monetary policy. Part of the obligation is due to the raising of funds from TARGET2 for investments in euro.

This item also includes the net liability arising at year-end from the difference between monetary income pooled and distributed.

11. Items in the course of settlement

This is mainly a liability to the government

Table 11 Provisions

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Pension benefits	113.353	98.351	15.002
Provision against risks arising from the main activities of the CBC	55.000	40.484	14.516
Special provision in respect of monetary policy operations	7.188	10.279	(3.091)
Provision for the minting of coins and the supply of banknotes in euro	6.216	11.150	(4.934)
Total	181.757	160.264	21.493

Table 12 Pension benefits

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Present value of the obligation	113.353	122.802	(9.449)
Unrecognised past service deficiency	0	(24.451)	24.451
Net obligation in the balance sheet	113.353	98.351	15.002

and results from the operations of the Cyprus Clearing House for cheques.

12. Other liabilities

12.1 Off-balance sheet instruments revaluation differences

This item reflects the valuation of contracts for the exchange of currencies on the basis of the exchange rates ruling at the end of the year.

13. Provisions (Table 11)

Pension benefits

The CBC operates a non-funded pension

scheme which provides benefits to retired employees that are based on the employees' final pensionable salary. Employee contributions are made only in respect of widows and orphans benefits. The pensionable service liability of the CBC is reviewed at regular intervals by independent qualified actuaries. The latest actuarial valuation was carried out as at 31 December 2009 and revealed a past service deficiency of €4,1 million. On the basis of recommendations from the actuaries, the unrecognised past service deficiency was charged in full to the

Table 13 **Movement in net obligation**

	2009 €'000	2008 €'000	Change €'000
Net obligation as at 1 January	98.351	87.429	10.922
Provision for the year	12.954	6.752	6.202
Capitalisation of interest	4.816	5.834	(1.018)
Employee contributions to the widows and orphans fund	179	148	31
Benefits paid	(2.947)	(1.812)	(1.135)
Net obligation as at 31 December	113.353	98.351	15.002

accounts for 2009. In addition, on the basis of the actuaries' recommendations, the normal contribution has been reduced from 28,9% to 23,4% of the salaries. The next actuarial valuation is planned to be carried out with reference date 31 December 2012. The present value of the obligation is the same as the balance sheet obligation as at 31 December 2009 (**Table 12**, p. 85).

Payments of pensions and one-off retirement benefits during 2009 have, as in previous years, been charged directly to the provision for pension benefits (**Table 13**).

Provision against risks arising from the main activities of the CBC

The CBC maintained a provision against market risks, as measured and expressed by the VaR (Value at Risk), which is calculated using the "parametric VaR" methodology with a 95% confidence level and a time horizon of one year.

The CBC's Board of Directors decided to replace the above provision with a general

provision against all risks emanating from the main activities of the CBC and relate to credit and operating risks, market risks (interest rate and foreign exchange rate risks), monetary policy operations risks and liquidity risks.

The Board of Directors decided that the level of this provision for 2009 should be €55 million, to be built up with the transfer of the balance of €40,5 million of the current provision for market risks and the remaining amount of €14,5 million to be transferred from the income and expenditure account.

Special provision in respect of monetary policy operations

In accordance with the general accounting principle of prudence, the Governing Council of the ECB deemed it appropriate to establish a provision totalling €5.736 million against counterparty risks in monetary policy operations. In accordance with article 32.4 of the ESCB Statute, this provision is funded by all the NCBs of participating member states in proportion to their subscribed capital key in

Table 14 **Revaluation accounts**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Pre-stage III revaluations	241.306	243.133	(1.827)
Currency revaluations	94.401	38.879	55.522
Price revaluations	33.830	43.935	(10.105)
Total	369.537	325.947	43.590

the ECB prevailing in 2008. As a result, and based on the CBC subscribed capital key which was 0,17921% in 2008, the share of the CBC provision amounted to €10,3 million.

At its meeting on 4 February 2010, the Governing Council of the ECB decided to reduce the overall provision to €4.011 million with effect from 31 December 2009. As a result the share of the CBC as at 31 December 2009 was reduced to €7,2 million.

Provision for the minting of coins and the supply of banknotes in euro

This provision refers to the expected cost of the minting of coins and the supply of banknotes in euro. During 2009 an amount of €4,9 million was released to cover the cost of the minting of coins.

14. Revaluation accounts

In accordance with the rules and accounting principles established by the ECB, unrealised gains from the revaluation of gold, financial instruments in foreign currency and securities are not recognised as income in the profit and

loss account but are transferred directly to revaluation accounts (which operate as reserves solely for the specific assets). On the other hand, unrealised losses resulting from revaluations at the end of the accounting period and which exceed unrealised profits previously transferred to the revaluation accounts are recognised as expenses and transferred to the profit and loss account.

The revaluation at the end of 2009 resulted in unrealised gains of €43,6 million (2008: €82,8 million) which were transferred to the corresponding revaluation accounts and are shown in more detail in **Table 14**. In addition, part of the unrealised gains as at 1 January 2008, which formed part of the pre-stage III adjustments, were realised in 2009 through the sale of the underlying securities.

These amounts represent a safety reserve against future possible adverse moves in the prices of gold and securities and in the exchange rates of currencies in which foreign currency reserves are maintained.

Table 15 **Capital and reserves**

	31 Dec 2009 €'000	31 Dec 2008 €'000	Change €'000
Capital	30.000	30.000	0
General Reserves	33.623	31.807	1.816
Total	63.623	61.807	1.816

15. Capital and reserves (Table 15)

The increase in the General Reserves represents 20% of the net surplus for 2008. In accordance with the provisions of the *Central Bank of Cyprus Law, 2002-2007*, 80% of the net surplus was transferred to the government general account.

Off-balance sheet instrumentsHedging against exchange risks

In 2009 the CBC conducted currency swap and

forward transactions in line with the currency risk hedging strategy. The forward leg of the outstanding currency swap and forward transactions as at 31 December 2009, amounting to \$824 million and ST£201 million, form part of the off-balance sheet accounts.

INCOME AND EXPENDITURE ACCOUNT FOR 2009

Table 16 **Net interest income**

	2009 €'000	2008 €'000	Change €'000
Interest income on			
Foreign exchange assets	34.188	39.866	(5.678)
Euro denominated assets	102.880	99.938	2.942
Claims arising from transfer of reserve assets to ECB	869	2.501	1.632)
Net claim on euro banknote position	1.714	7.743	(6.029)
Lending on credit institutions	77.770	51.741	26.029
Credit facility to government	47.221	48.595	(1.374)
Staff loans	181	388	(207)
Total interest income	264.823	250.772	14.051
Interest expense on			
Liabilities in foreign currency	12.002	7.577	4.425
TARGET2 liability	80.741	105.182	(24.441)
Minimum reserves	16.103	46.346	(30.243)
Other deposit facilities to credit institutions	841	1.321	(480)
Other euro denominated liabilities	26.543	23.735	2.808
Total interest expense	136.230	184.161	(47.931)
Net interest income	128.593	66.611	61.982

1. Net interest income (Table 16)

2. Net result from financial operations, writedowns and risk provisions

Writedowns on financial assets and positions largely reflect the decline in the market value of the US dollar against the euro as compared to the average cost of the dollar at 31 December 2009, as well as the reduction in the market value of securities compared with the average cost vis-a-vis 31 December 2009.

4. Income from equity shares and participating interests

On 17 December 2009, the Governing Council of the ECB decided on the distribution to the NCBs of an amount equal to €787,2 million from its seigniorage income (8% of the euro banknotes in circulation). The share of the CBC in this distribution amounts to €1,5 million. In addition, on 4 March 2010 the Governing Council decided to distribute the net profit for 2009 amounting to €1.500 million. The CBC's share amounts to €2,8 million.

5. Net result of pooling and redistribution of monetary income

Monetary income is the income pooled by the NCBs in carrying out their obligations in the performance of the Eurosystem monetary policy operations.

The monetary income of each NCB is determined by measuring the actual annual income derived from the earmarked assets held against its liability base. The liability base consists of the following items:

- Banknotes in circulation;
- Liabilities to credit institutions related to monetary policy operations denominated in euro;
- Net intra-Eurosystem liabilities resulting from TARGET2 transactions;
- Net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem.

Any interest paid on liabilities included within the liability base is to be deducted from the monetary income to be pooled.

The earmarked assets consist of the following items:

- Lending to euro area credit institutions related to monetary policy operations denominated in euro;
- Intra-Eurosystem claims equivalent to the transfer of foreign reserves to the ECB;
- Net intra-Eurosystem claims resulting from TARGET2 transactions;
- Net intra-Eurosystem claims related to the

allocation of euro banknotes within the Eurosystem;

- A limited amount of each NCB's gold holdings in proportion to each NCB's capital key share.

Where the value of an NCB's earmarked assets exceeds or falls short of the value of its liability base, the difference shall be offset by applying to the value of the difference the latest available marginal rate for the Eurosystem's main refinancing operations.

The monetary income pooled by the Eurosystem is allocated among NCBs according to the subscribed ECB capital key. The difference between the monetary income of €32,7 million pooled by the CBC and the €22,3 million reallocated to the CBC is the net result (€10,4 million) arising from the pooling and redistribution of monetary income. This item also includes €120.000, which is the CBC's share to the revisions made in the reallocation of monetary income of 2008.

6. Other income

The main part of other income, amounting to €36,5 million, relates to the value of the Cyprus currency coins not returned by 31 December 2009, which was the last date of exchange of the Cyprus currency coins to euro in accordance with the provisions of the *Adoption of the Euro Law, 2007*.

Table 17 **Staff costs**

	2009 €'000	2008 €'000	Change €'000
Basic salaries	14.109	13.153	956
Cost of living allowance	3.187	2.602	585
Social insurance and other contributions	2.401	2.167	234
Overtime and other allowances	1.099	1.116	(17)
Staff training	105	138	(33)
Provision for pension fund	17.770	12.570	5.200
Total	38.671	31.746	6.925

Table 18 **Provision for pension fund**

	2009 €'000	2008 €'000	Change €'000
Current service cost	6.234	4.100	2.134
Interest on pension fund obligation	4.816	5.834	(1.018)
Past service cost	6.720	2.636	4.084
Total	17.770	12.570	5.200

7. Staff costs

Staff costs are analysed in **Table 17**

Provision for pension fund

The charge to the provision for the employees' retirement benefits is included in the provisions and is analysed in **Table 18**.

Table 19 **Main Actuarial Assumptions**

Discount rate	4,80%
Average rate of total salary increases	3,00%
Inflation rate	2,00%
Rate of increase in the basic insurable earnings	3,50%
Rate of increase in pensions	3,00%
Rate of increase in social insurance payments	2,00%

Main Actuarial Assumptions

The main actuarial assumptions used for the actuarial valuation performed with reference date 31 December 2009, are presented in **Table 19**.

8. Administrative expenses

Administrative expenses include telecommunications, insurance and maintenance of building and equipment, utility expenses, travelling and other miscellaneous expenses.

Contingent liabilities and commitments

During 2009 the CBC undertook commitments for information technology projects amounting to €1,2 million.

Independent Auditor's Report to the Board of Directors of the Central Bank of Cyprus

Report on the Financial Statements

We have audited the accompanying financial statements of the Central Bank of Cyprus (the "Bank") on pages 73 to 92, which comprise the balance sheet as at 31 December 2009, and the income and expenditure account for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Governor's and Board of Directors' Responsibility for the Financial Statements

The Governor and the Bank's Board of Directors are responsible for the preparation of financial statements that give a true and fair view in accordance with article 57(2) of the *Central Bank of Cyprus Law, 2002-2007*, in conformity with the accounting principles applicable in the European System of Central Banks (ESCB) as these are determined by the European Central Bank (ECB) in the Accounting Guideline ECB/2006/16 as amended by guidelines ECB/2007/20, ECB/2008/21, ECB/2009/18 and ECB/2009/28. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on

these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board of Directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give

a true and fair view of the financial position of the Central Bank of Cyprus as of 31 December 2009, and of its financial performance for the year then ended in accordance with article 57(2) of the *Central Bank of Cyprus Law, 2002-2007*, in conformity with the accounting principles applicable in the European System of Central Banks (ESCB) as these are determined by the European Central Bank (ECB) in the Accounting Guideline ECB/2006/16 as amended by

guidelines ECB/2007/20, ECB/2008/21 and ECB/2009/28.

Other Matters

This report, including the opinion, has been prepared for and only for the Bank's Board of Directors as a body and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whose knowledge this report may come to.

PricewaterhouseCoopers Limited
Chartered Accountants
Nicosia, 15 March 2010

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