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Trip Notes: Cyprus

Key notes from our recent trip to Nicosia: May 25th

On May 25, we traveled to Cyprus where we met with high-level officials from the Finance Ministry, the Central Bank, think tanks as well as market participants from the domestic financial sector. The present note attempts to offer our readers a cohesive overview of current conditions in the domestic economy and markets and the outlook ahead

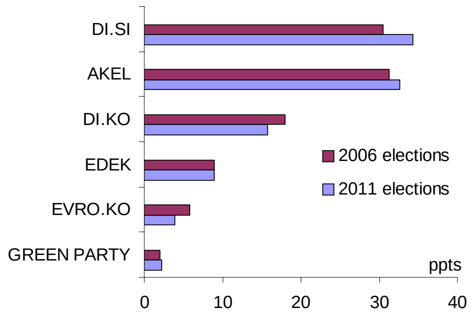
Key points

- **Right-wing main opposition party wins May's general elections; outcome bears little impact on the current political landscape, for now**
- **Domestic economy rebounded from recession in H1 2010**
- **A timid, yet still unbalanced, economic recovery is underway; GDP growth is seen accelerating further next year**
- **Additional measures are needed to bring the fiscal position to a more sustainable path**
- **Credit ratings under downward pressure on fiscal-related jitters and euro area spillover worries, but domestic financial system remains well positioned to weather potential shocks**
- **Current account improvement driven by lower private-sector demand for imports**

Right-wing main opposition party wins May's general elections…

Cyprus's right-wing main opposition party, Democratic Rally (DI.SI), narrowly led the tally in the country's general elections held on May 22 (Table 1). Having collected 34.28% of the vote, it outran the ruling communist Progressive Party of the Working People (AKEL), linked to President Demetris Christofias, which was the runner up with 32.67% of the ballot. Turnout was 78.7% of the eligible electorate. In spite of the seemingly large percentage of participation, abstinence was the highest on record as voting in Cyprus is compulsory. Public support for both frontrunners increased since the previous 2006 elections, prompting both parties to translate the outcome as a victory. In detail, DI.SI won an extra 3.76ppts, while support for AKEL improved by 1.36ppts. On the flipside, the junior coalition partner Democratic Party (DI.KO) followed third with 15.76%, having lost 2.22% of public support since 2006. In total, six parties entered parliament, with 20 seats won by DI.SI, 19 by AKEL, 9 by DI.KO, 5 by Movement for Social Democracy (EDEK), 2 by European Party (EVRO.KO) and 1 by the Green Party.

Table 1: 2011 parliamentary elections results



Sources: Ministry of the Interior

…but outcome bears little impact on current political landscape, for now

As the Cypriot government system is presidential, May's elections did not have an immediate effect on the ruling coalition cabinet. The primary impact was a realignment of the number of seats political parties occupy in the House of Representatives. On the other hand the poll may be seen as a key gauge for public support for the government. The latter holds especially for President Christofias's policies over the burning issue of a reunification plan of the island.

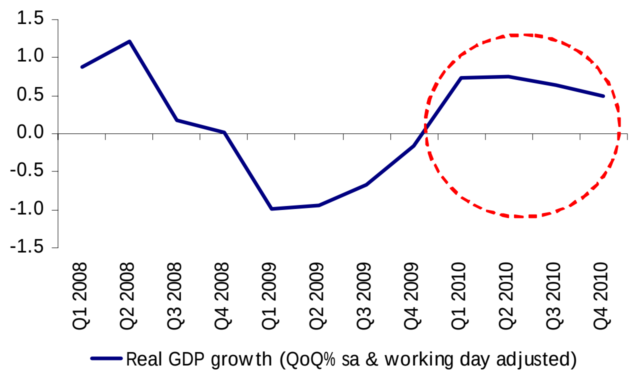
Cyprus has been divided since 1974 between the internationally recognised Republic of Cyprus part and a Turkish enclave recognised solely by Ankara. After a failed attempt which had ended with the Annan Plan referendum blackball in 2004, reunification talks were launched in 2008. The UN has signalled it wants to resolve the issue before mid-2012, when Cyprus takes over the EU Presidency. However, little progress has been made so far. President Christofias has proposed a rotating presidency under a weighted voting system. He has also proposed permission to a large number of Turkish settlers to remain in the northern part of the island. But, political parties have criticised his plan. The government has also been criticised for a lagged reaction to the global financial crisis that had pushed the country into recession in 2009.

The election of EDEK's Yiannakis Omirou as Parliament Speaker was considered as a setback for the ruling allies AKEL and DI.KO, both of which supported the latter's head and incumbent Marios Garoyian's candidacy. The position of Parliament Speaker is considered as the second most important in Cyprus after the President. Omirou's election could cause bottlenecks in the government's bill-passing ability in parliament. Meanwhile, the opposition's victory in the general ballot suggests that incumbent President Demetris Christofias, or any other potential candidate from the ruling coalition parties, may find it difficult to win a (new) term in the office. That said, Presidential elections are not due before February 2013.

Domestic economy exited recession in H1 2010

The domestic economy bounced out of recession in H1 2010 (Figure 1) after a 1.7%yoy contraction in 2009. The recovery was primarily driven by financial intermediation (+2.4%yoy) as well as the tourism (hotels & restaurants +2.4%yoy, arrivals +1.5%yoy, revenues +3.8%yoy), transport (+1.5%yoy) and trade (+0.2%yoy) sectors. On a negative note, construction and manufacturing remained in a contractionary territory (-1.6%yoy, -5.5%yoy, respectively) as home purchases remained weak. From the demand side, a sharp adjustment in inventories after the 2009 destocking and a mild rebound in private consumption (+0.8%yoy), assisted by ongoing growth in wages, were the main drivers of growth last year. On the other hand, investment declined by nearly 8%yoy.

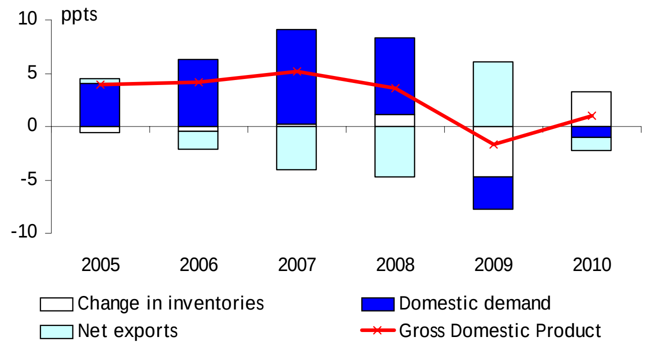
Figure 1: Domestic economy bounced from recession in H1 2010



Sources: Statistical Service

Although exports staged a modest rebound, driven primarily by strong external demand for services, net exports' contribution turned negative as imports' growth of 3.1%yoy outpaced a 0.6%yoy recovery in exports. The latter was against a background of a slowly recuperating consumption (+0.7%yoy) and one-off import items, such as busses and other equipment.

Figure 2: Real GDP growth and contribution breakdown



Sources: Statistical Service, Eurobank EFG

Table 2: Real GDP break down and contributions

Cyprus: GDP	YoY growth (ppts)		Contributions (ppts)	
	Q4 '10	2010	Q4 '10	2010
GDP	2.5	1.0		
Expenditure-side				
Domestic Demand	7.0	2.2	7.3	2.3
Consumption	6.7	0.7	6.3	0.6
Private Consumption	4.1	0.8	2.9	0.5
Govern. Consumption	0.0	0.5	3.4	0.1
Investment	-8.4	-7.9	-1.8	-1.6
Change in stocks	-	-	2.8	3.3
Net exports	-	-	-4.9	-1.2
Exports	1.3	0.6	0.5	0.3
Imports	11.7	3.1	-5.4	-1.5
Production-side				
Agriculture, hunting, forestry & fishing	-0.9	1.5	0.0	0.0
Mining & quarrying, manufacturing, electricity, gas and water	-1.5	-0.5	-0.1	0.0
Construction	-3.6	-5.5	-0.3	-0.4
Wholesale & retail trade, Hotels & Restaurants, transport, storage and comm.	6.3	1.1	1.4	0.3
Financial intermediation, real estate, renting & business	3.4	2.8	0.9	0.7
Public administration & defence, education, health and social work, other services	1.2	1.7	0.3	0.4
Import duties plus VAT	2.9	1.0	0.3	0.1

Sources: Statistical Service, Eurobank EFG

A timid, yet unbalanced, economic recovery is underway; GDP growth is expected to accelerate further in 2012

Real GDP expanded at an annual pace of 1.8% in the first quarter of this year. With the breakdown of the data to be released later in June, the Statistical Service noted that construction and manufacturing remained in a contractionary territory, with positive GDP growth driven primarily by the ongoing rebound in trade, tourism, banking and services sectors. These growth patterns are likely to persist for the greater part of this year, with further improvement anticipated in sectors already exhibiting positive dynamics and ailing sectors continuing to stagnate. Tourism and other services are likely to remain main driver of domestic economic activity this year. A strong recovery is already evident in the tourism sector, with the MENA turmoil and strong rebounds in the German and Russian economies providing a strong lift. Confirming the latter view, the number of foreign arrivals soared by 43%yoy in April and a further improvement is anticipated in May. Over the first four months of the year the influx of foreign visitors registered a 17.6%yoy increase, following an 8.2%yoy decline in the same period a year earlier. Meanwhile, revenues in the sector rose by 24%yoy year-to-April 2011. A small recovery is also witnessed in domestic trade, with the January-February retail sales volume rising by 2.6%yoy and the turnover value index advancing by 7.1%yoy. On the other hand, construction and manufacturing remain key drags on domestic economic activity, continuing their adjustment from the overheating conditions witnessed in the years prior to the 2009 recession. According to most recent data, both sectors are faring worse so far this year compared to last and are braced to partially offset the recovery in other sectors of the economy.

Signaling that the troubles in the industrial sector are far from over, the corresponding production index fell 5.9%yoy in March, pushing the annual rate of contraction to 3.2% in Q1 compared to a 0.7% fall registered over the same period a year earlier. In a similar vein, manufacturing declined by 6.0%yoy in January-March after a 3.5%yoy drop in Q1 2010. Separately, building permits, a leading indicator of future construction activity, registered a 13.4%yoy decline in Q1 2011, having recorded a 10%yoy rise over the same period a year earlier. Moreover, the total value of permits plummeted by 23.6%yoy, following an 11.1%yoy rise in Q1 2010. Along these lines, real GDP is likely to expand at an annual pace of 1.7% this year from growth of 1.0% registered in 2010. For 2012, a further acceleration to 2.3% is expected as global as macroeconomic conditions strengthen and domestic demand dynamics improve further.

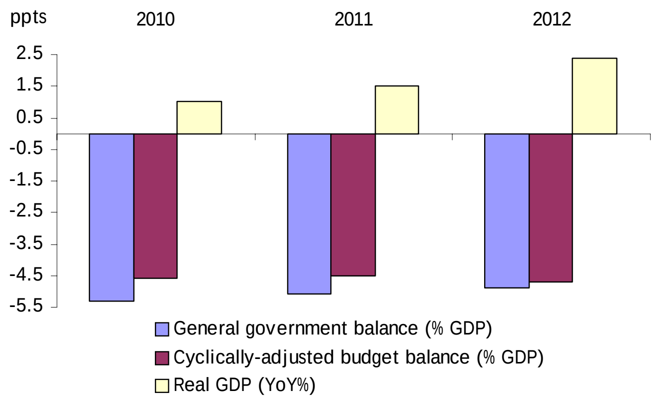
Further measures needed to enhance fiscal consolidation

Cyprus's public finances have undergone a trend-deterioration in recent years. After posting fiscal surpluses of 3.4%-of-GDP and 0.9%-of-GDP in 2007 and 2008, respectively, the general government balance swung to a 6.0%-of-GDP shortfall in 2009. In part, cyclical factors in tandem with stimulus measures utilized in order to weather the 2009 recession were to blame. However, the primary culprits of the persisting fiscal worsening are structural weaknesses, mostly on the expenditure side. These include, among others, a high public wage bill, untargeted social transfers and civil servant benefits. The contraction in the real estate sector is also taking a toll on government finances as income from sales taxation has reduced significantly. According to the European Commission's 2011 Spring Forecasts, Cyprus's cyclically adjusted budget deficit will mark a marginal improvement to this year, to 4.5%-of-GDP from 4.6%-of-GDP in 2010 (Figure 3). But, a further deficit widening to 4.7%-of-GDP is expected next year, despite higher projected GDP growth. The latter suggests that additional fiscal measures, primarily of structural nature, will need to be employed in order to achieve a more sustainable fiscal improvement in the coming years.

The government is targeting a general government budget gap of 4%-of-GDP in 2011, having outperformed last year's deficit target by a considerable margin (5.3%-of-GDP deficit realization vs. a 6%-of-GDP official target). However, last year's outcome was favored by one-off factors, including revenues from an interest-swap agreement and increased Central Bank profits. Until now, the government has adopted a number of measures in order to curtail the fiscal deficit in the years ahead and eventually reverse the upward trend of the debt-to-GDP ratio. These account for ca 1.5pts of GDP and envisage pushing the deficit to 2.5%-of-GDP by 2012. Among others, these include: heightened control over public sector hiring, a reduction in the number of civil servants (by 1,000 per annum this year and the next), introduction of a spending ceiling on certain expenditure categories, imposition of a 5ppts VAT increase on food products and pharmaceuticals (from 0% before) as of January 2011, increases in excise taxes on petroleum and tobacco items as of June and December 2010, respectively, and adoption of a 0.095% levy on banks' deposits.

The measures also include a town planning amnesty for buildings with minor irregularities and containment of tax evasion. Under the Stability Programme, Cyprus also plans to implement a reform of the existing wage indexation mechanism COLA (Cost Of Living Allowance), restrain the public sector wage setting process, strengthen one-stop shop arrangements for investors, preserve a low-tax haven status and reduce red tape and administrative costs. Negotiations between the government and unions are already underway aimed at agreeing over slower wage increases ahead that are estimated to generate €70mn of savings over the next two years.

Figure 3: In spite of the economic recovery, public finances are likely to improve only marginally



Sources: EC Spring forecasts 2011

Q1 2011 budget execution data call for additional austerity measures

Budget execution data for the first quarter of this year suggest that additional measures have to be implemented in order to ensure fulfillment of the 2011 deficit target. In detail, the overall general government deficit widened by ca 200%yoy to €310.7mn over the January-March period. Revenues declined by 6.6%yoy to €1.599bn, while expenditure increased by 5.2%yoy to € 1.909bn. Revenues from primary sources of income, such as taxes on production and imports (-4.5%yoy to €588.3mn) as well as on income and wealth (-7.2%yoy to €426.8mn) deteriorated relative to the same period a year earlier. On a less negative note, revenue from sales of goods and services marginally improved (+3.7%yoy to €105.9mn). From the expenditure side, employees' compensation, social transfers and intermediate consumption all rose on an annual basis (+2.5%, +6.7%, +6.4% to €628.6mn, 623.8mn, €185.7mn, respectively). In addition, capital formation and current transfers fell (-7.4%yoy and -7.5%yoy to €105mn and 185.7mn, respectively).

Sovereign credit ratings under downward pressure on fiscal and euro area contagion-related worries …

Downward pressures on Cyprus's sovereign credit ratings have intensified in recent months, with major agencies citing a high exposure of the domestic banking sector to Greek debt as well as fiscal slippage and lack of reforms (Table 2). In February, Moody's downgraded Cyprus's sovereign credit ratings by two notches to A2 and in May placed the country's ratings under review for a possible downgrade. According to Moody's, Cypriot bank lending to the Greek private sector accounts for around 41% of total loans on an aggregate basis. The agency acknowledged that the banking sector is currently well-capitalized and has a strong shock absorption capacity under a stress scenario. Meanwhile, S&P cut Cyprus's rating by one notch to A- in March (its second cut in five months), leaving the door open for further downgrades. According to the agency's calculations, Cypriot banks exposure to Greece through holdings of Greek sovereign and bank debt (and via the loans books of their subsidiaries in Greece) amounts to €30.5bn or 168%-of-GDP. S&P estimates that the Cypriot government will need to spend around €1.3-2.0bn (6-10%-of-GDP) in case it is required to support the banking sector under a severe stress scenario. On similar grounds, a three –notch downgrade to A- with negative outlook came by Fitch in May.

Table 2: L-T Foreign Currency Ratings under downward pressure

	Current Rating	Date of last rating action	Action	Outlook
Fitch	A-	31/5/2011	3-notch down	Negative
S&P	A-	30/3/2011	1-notch down	Negative
Moody's	A2	16/5/11	On review for a possible downgrade	Negative

Sources: Bloomberg

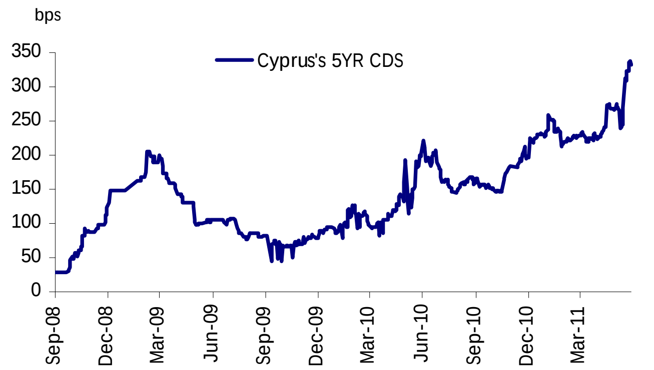
…however, domestic banking system is well positioned to weather potential spillover effects

The size of the Cypriot banking sector is admittedly large relative to the domestic economy. At the end of last year, total banking system assets accounted for 893%-of-GDP with Cypriot bank assets accounting for around 680% of GDP. The high concentration of the sector may be also an area of concern, with Bank of Cyprus, Marfin Popular Bank, Hellenic Bank and the Greek subsidiary of Alpha accounting for ca 56% of total consolidated banking assets. Along these lines, spillover risks from the euro area debt crisis could result to a deterioration in the sector's asset quality and under a stress scenario banks could require the assistance of government funding. If such a scenario were to materialize, it would strain the already ailing state finances further and hurt the fragile recovery.

Notwithstanding the aforementioned, Cyprus's financial sector is adequately capitalized as suggested by a range of soundness indicators. Capital adequacy ratio stood at 12.2% at the end of last year, above the minimum threshold of 8%. Following a rights issue by Marfin Popular Bank in February 2011, this ratio is estimated to have increased to 12.8%. According to the ministry of finance, subsidiaries of foreign banks account for ca 23% of the total banking system, with substantial amounts of their assets relating to booking transactions funded by their parents, which in most cases retain the credit risk. Domestic bank loans granted to customers in Greece total around €24bn, or 137%-of-GDP (end-201o data). The ministry estimates that other exposures to Greek assets amount to ca €7bn, with some €5.7bn corresponding to Greek government bond holdings (end-2010 data).

NPLs stood at 7.4% in December last year, having risen from 5.9% at the end of 2009. With various legal bottlenecks causing delays in settlements and liquidations, a recovery in NPLs will likely be evidenced in the data with a certain delay. Total loans-to-deposits ratio stood below unity at around 89% in April. Currently, two different entities perform banking-sector supervision; namely, the CBC and the Co-operative Societies Supervision and Development Authority. Moreover, the CBC has imposed a 70% minimum stock liquidity requirement on FX deposits and a 20% ratio on local currency deposits, accompanied by maximum mismatch ratios for short-term maturities up to one month. Meanwhile, a maximum 70% loan-to-value ratio exists in property financing with a higher share of 80% for primary residence. Another indication of the sector's capacity to absorb shocks was the mid-summer 2010 EU stress tests, in which Bank of Cyprus and Marfin Popular Bank participated and passed successfully. Since then both banks have sought to strengthen their capital position. The former proceeded with a €345mn rights offering in October last year and a convertible bond issuance last month which received subscriptions of ca €890mn, out of which €696mn were in the form of exchange of Existing Eligible Securities. On the other hand, Marfin Popular Bank raised €488.3mn through rights issue in February 2011. In addition, it sold 85% of its stake in Australian subsidiary for €104.3mn and recently received approval to offer €294mn of convertible bonds. Moreover, the government in partnership with the CBC announced in March it was setting up a permanent Financial Stability and Resolution Fund anticipated to be ready by September and expected to accommodate ca €500mn of support for the country's banking sector, if needed.

Figure 4: Five-year CDS spreads near record peaks



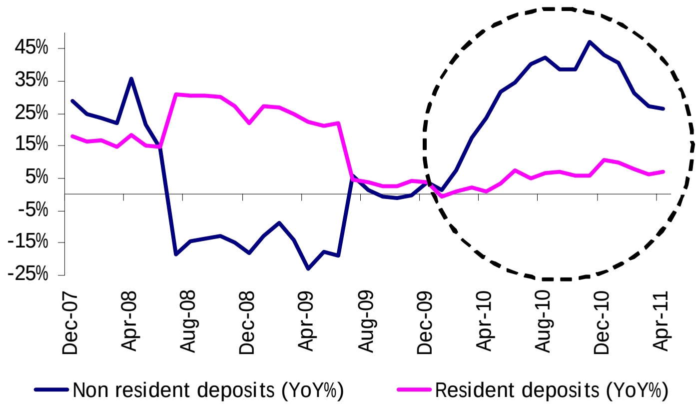
Sources: Bloomberg

This accounts to ca 3%-of-GDP. The creation of the Financial Stability and Resolution Fund constitutes a step towards the right direction. Importantly, in spite of the recent downgrades and widening pressures on the country's CDS spreads (Figure 4), confidence towards the domestic banking system remains remarkably strong. This is evidenced by ongoing growth in deposits (Figure 5). In spite of a slowdown in annual growth of non-resident deposits from levels above 40% earlier this year, April's print of 26.6% confirms that domestic banks continue to receive a strong influx of foreigners' money. It is also worth mentioning that non-resident deposits account for 37% of total deposits in Cyprus.

Current account improvement driven by lower imports

Cyprus's current account deficit has improved markedly from levels near 17%-of-GDP reached in 2008. The sharp narrowing witnessed was primarily thanks to a shrinking trade deficit which was, in turn, driven by weak domestic demand dynamics. With respect to the trade in goods, in 2009 and 2010 weaker imports in transportation after the previous two booming years and a retreat in oil prices from record highs in mid-2008 induced narrowing pressures on the shortfall.

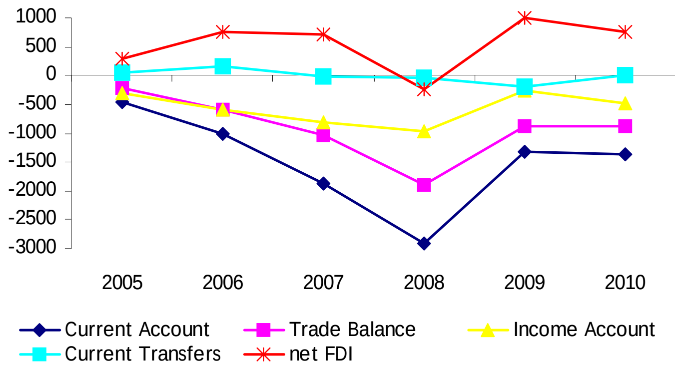
Figure 5: Growth of non-resident deposits in Cyprus remains strong in spite of a recent slowdown



Sources: CBC, Eurobank EFG

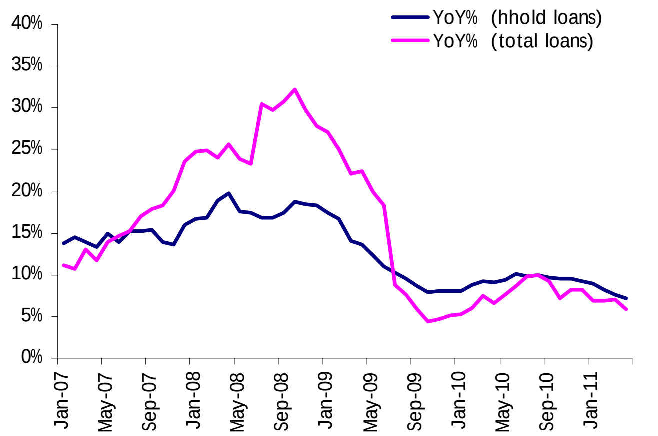
In contrast to the trade of goods that is generating a shortfall, the trade of services traditionally produces a surplus that partially helps to contain the current account deficit. As such, a rebound in exports of business services and tourism, which account for most of the exports in services (cumulatively ca 56% of total exports in services), favored significantly last year. Another issue worth mentioning is the nature of the income account, which corresponds to around 35% of the current account deficit (Figure 6). Changes in the income account are largely affected by foreign companies' profitability as their gains are recorded as outflows in the income account only to be registered as FDI inflows in the Financial Account. In other words, this accounting method artificially increases the current account deficit with a few extra ppts (i.e., by as much as 3-4ppts). Notwithstanding the aforementioned, the CA remains at elevated levels and is likely to stay around the 8%-of-GDP this year and the next. Contained private credit growth may alleviate widening pressures stemming from the domestic demand side, while improving global macroeconomic conditions are expected to provide a lift to exports and, particularly, exports of tourism and other services. The MENA turmoil is also expected to favor foreign arrivals in the months to come. It is also worth noting that lending activity has slowed down lately (Figure 7). In support of the aforementioned, total loans rose by 5.9%yoy in April, with growth having nearly halved from a 1-½-year peak of 10% in August last year.

Figure 6: Current account gap mainly driven by deficits in the trade and income accounts



Sources: CBC

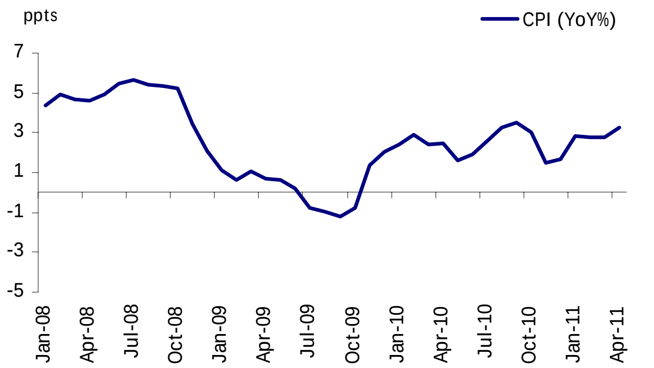
Figure 7: Credit growth slowdown continues



Sources: CBC, Eurobank EFG

Furthermore, foreign companies' profitability is unlikely to rebound to the pre-crisis levels any time soon and as such, it is unlikely to affect the current account shortfall as significantly as in the period before the crisis. On the flipside, Cyprus's high dependence on energy imports, such as oil, remains a key risk. And, with oil prices on the rise, a significant narrowing of the shortfall is unlikely this year or the next. Notwithstanding the aforementioned, higher oil prices, which favor Russia's economy, will, in turn, support additional income as well as deposits from there.

Figure 8: Inflation pressures relatively subdued in view of weak domestic demand dynamics



Sources: Statistical Service, Eurobank EFG

Inflation pressures remain subdued, reflecting weak domestic demand dynamics

Inflation remains subdued as domestic demand dynamics (excluding inventories) remain weak. However, the hikes in excise duties on petroleum and tobacco products as well as higher energy and commodity prices have lately pushed headline CPI to levels above 3%yoy from an average of 0.3%yoy in 2009 (Figure 8). Nevertheless, low core inflation readings suggest that underlying price pressures remain relatively contained.

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