Written By:

Galatia Phoka:
Emerging Markets Analyst

Moody's downgrades Cyprus's sovereign credit ratings on fiscal concerns, banking sector exposure to Greece

- **Rating announcement not a complete surprise**
- **Sustainable fiscal consolidation is a key policy challenge ahead**
- **Moody's concerned about domestic banking sector's exposure to Greece**

Moody's downgraded Cyprus's sovereign credit ratings by two notches

Moody's downgraded Cyprus's sovereign credit ratings by two notches to A2 on February 24, citing **a)** domestic banking sector's high exposure to debt-laden Greece, **b)** structural macro issues exerting deteriorating pressures on public finances and, to a lesser extend, **c)** concerns about the country's competitiveness. The agency assigned a stable outlook on its rating.

Rating announcement not a complete surprise

Moody's decision did not come as a complete surprise. A month earlier the agency had warned about a potential multi-notch downgrade, placing Cyprus under negative watch. The agency had noted back then that the island's sovereign rating would likely remain within the investment grade band. On similar grounds, S&P cut in November Cyprus's credit rating by one notch to A with a negative outlook. Meanwhile, Fitch placed Cyprus on a negative watch in January, with the review expected to be completed by April, thus leaving the door open for yet another downgrade.

Sustainable fiscal consolidation key policy challenge ahead

Cyprus's public finances have deteriorated significantly over the past two years. The budget deficit swung from an average annual surplus of 2.15%-of-GDP in 2006-2007 to a deficit of 6%-of-GDP in 2009 with a small improvement to around 5.5%-of-GDP estimated last year. Meanwhile, the debt ratio likely exceeded 60%-of-GDP in 2010, having embarked on an uptrend from levels near 48%-of-GDP in 2008. Importantly, the deterioration has not been solely driven by cyclical factors and the economic stimulus measures employed to ease the impact of the crisis. It has also been a reflection of structural weaknesses, especially on the spending side, including a rising bill for wages and pensions and untargeted social transfers. It is worth mentioning that state payroll accounts for ca 30% of annual public spending, while civil servants make up for ca 7% of the 800k population. As such, even though stimulus measures are gradually reversed and GDP growth returns to positive territory, additional fiscal tightening will likely be needed in order to eliminate the excessive deficit and bring the fiscal position to a more sustainable path.

Further measures needed to ensure a sustainable consolidation path longer-term

The government has already employed a number of measures aiming to contain the deficit to just under 4%-of-GDP this year (*i.e.,* 0.5ppts below the EU-agreed target), and to reduce it below 3%-of-GDP by 2012. Among others, these measures include a freeze in new hires and a downsizing of the overall public-sector labor force. Finance Minister Charilaos Stavrakis recently said that the number of public employees was reduced by 1,040 in 2010 and that it will decline by a further 2,000 by end-2012, generating annual savings of ca €35mn. Furthermore, allowances for retired civil servants' unemployment benefits after departure have been scraped, operating expenditures were reduced and infrastructural projects are now better prioritized. A 5ppts hike in the VAT rate for food and medication products and additional taxation on tobacco have been introduced this year, while plans for a 0.05% tax on bank deposits above €100k are also on the cards. However, as noted by the IMF in mid-February, "it would be more preferable to base the adjustment more on structural expenditure restrain and less on revenue". And although the government has already taken a number of steps to improve tax receipts, growth in public-sector wages and social transfers may continue to significantly outpace its ability to raise revenues, especially given the country's low-tax destination status. The government has pledged to hold discussions with the unions in order to address pension costs. Yet, any radical progress on that front is unlikely ahead of May's general elections.

Moody's concerned about domestic banking sector's exposure to Greece

In its downgrade of Cyprus's sovereign debt, Moody's warned about the banking sector's size. Total bank assets currently amount to 925%-of-GDP (and 650%-of-GDP if foreign banks are excluded) according to Moody's estimates. The aforementioned figures do indicate an oversized sector compared to the domestic economy, which requires strong vigilance. The agency also expressed concern regarding the sector's exposure to debt-laden Greece, with the three largest domestic banks having over 40% of their total lending in Greece. Nevertheless, we see Cyprus's financial system to be strong enough to address potential challenges ahead. As Moody's acknowledged the current capital and liquidity levels do not pose as a source of concern. Indeed, the domestic banking sector has so far weathered well the global financial and eurozone's debt crises. Banks remain profitable with liquidity rations at comfortable levels (CAR at 12% in June 2010) and NPLs to private individuals relatively contained (around 8% of all loans as of September 2010). Meanwhile, as highlighted by the IMF in mid-February, the sector's reliance on deposits (rather than less stable sources of financing), conservative lending practices, close attention to capital and liquidity buffers, and vigilant supervision" are among the factors that have provided a cushion during the crisis.

Research Team

Editor - Professor **Gikas Hardouvelis**
Chief Economist & Director of Research Eurobank EFG Group

Financial Markets Research Division

Platon Monokroussos: *Head of Financial Markets Research Division*
Paraskevi Petropoulou: *G10 Markets Analyst*
Galatia Phoka: *Emerging Markets Analyst*

Sales Team

Nikos Laios, Head of Sales
Vassillis Gioulbaxiotis, Head of International Sales
Yiannis Seimenis, Ioannis Maggel, Corporate Sales
Stogioglou Achilleas, Private Banking Sales
Alexandra Papathanasiou, Institutional Sales

Economic Research & Forecasting Division

Dimitris Malliaropulos: *Economic Research Advisor*
Tasos Anastasatos: *Senior Economist*
Ioannis Gkionis: *Research Economist*
Stella Kanellopoulou: *Research Economist*
Olga Kosma: *Economic Analyst*
Maria Prandeka: *Economic Analyst*
Theodosios Sampaniotis: *Senior Economic Analyst*
Theodoros Stamatiou: *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr