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Notes from out Trip to Limassol & Nicosia, Cyprus, 14-16 April 2013

Earlier this month we visited Cyprus to participate in the *Global Russia Business Meeting* forum[1] (Limassol 14-15 April 2013), for which Eurobank Cyprus was a Strategic Partner. We also took the opportunity to visit Nicosia (16 April) and hold a number of meetings with key policy makers, government officials and prominent domestic analysts. Our discussions primarily focused on present situation in the domestic banking system as well as on the short- and medium-term prospects of the Cypriot economy in the context of the bailout agreement reached at the 25 March 2013 Eurogroup. In this note we highlight some of the main issues discussed during our meetings and provide an assessment of the domestic economic outlook as well as the future role of Cyprus as a regional business services hub.

Significant deterioration of domestic macro fundamentals in the period leading to the 25 March 2013 Eurogroup deal

Cyprus's macro fundamentals worsened considerably following the 2008/2009 global financial crisis, with the ensuing euro area sovereign debt upheaval and the munitions blast in the naval base of Mari in July 2011 taking a further toll on domestic economic activity. On the fiscal side, an overly generous and, in many instances, untargeted policy stance offered only temporary support to domestic output, albeit at the expense of undermining the country's sovereign solvency position. The general government balance switched from a surplus of 0.9%-of-GDP in 2008 to annual deficits in excess of 5%-of-GDP in 2009-20122[2], while the pace of real output contraction was contained at -1.9% in 2009. In the following two years, a feeble rebound was recorded (+1.3% in 2010 and +0.5% in 2011), but economic conditions have deteriorated anew since the third quarter of 2011, with full-year GDP declining by 2.4% in 2012.

Shrinking domestic demand was the driver of last year's recession, with net exports providing a partial offset. Private consumption dropped by 3.0%YoY, trimming around 2pps from full-year GDP growth, while investments contracted by 25.4%YoY, making a negative contribution of 4.8pps (Figure 1 –Annex). The domestic construction and manufacturing sectors were particularly affected, recording respective output losses of -19.6% and -6.9%. On a more positive note, the external sector was a positive contributor to 2012 GDP growth (to the tune of 4.7pps), reflecting a 3.6% YoY decline in the volume of imports and a 2.3%YoY rise in exports. The latter was mainly the result of higher revenue from tourism and business services.

[1] http://www.horasis.org/event_Russia_2013.php
[2] In cyclically adjusted terms, the general government balance underwent a significant deterioration over the aforementioned period, switching from a shortfall of ca 0.71%-of-GDP in 2008 to an estimated deficit of 4.95%-of-GDP in 2012. In a similar vein, the cyclically adjusted primary balance recorded a deficit of 1.3%-of-GDP in 2012, compared to a surplus of 2.1%-of-GDP in 2008.

Several factors weighed on business and consumer confidence last year, including, among others, the impact of the austerity measures implemented in late 2011, tightened lending standards in the domestic banking sector and lingering uncertainty emanating from the protracted negotiations with the EC/ECB/IMF troika of official lenders.[3] The domestic labor market also showed visible signs of deterioration, with unemployment reaching a historical-high rate of 12.1% late last year. Reflecting the aforementioned developments, Cyprus's gross public debt skyrocketed to 85.9% in 2012[4], from 71.1%-of-GDP in the prior year and 58.5% of GDP in 2009.

Overall, the political agreement on a bailout package for Cyprus reached at the 25 March 2013 Eurogroup found the domestic economy in a weakening phase.[5] To make things worse, the *once-vibrant* domestic banking sector has turned into a big liability for the Country. Taking advantage of the island's offshore status, the consolidated balance sheet of the domestic banking system had stretched as much as 550% of GDP in 2012[6]. However, Cypriot banks' relatively high exposure to the Greek market, the restructuring (PSI+) of Greece's sovereign government bonds (March 2012) and the ailing domestic real estate market inflicted significant losses on the sector, hurting the capital base of the country's two leading lenders, Cyprus Popular Bank (CPB) and Bank of Cyprus (BoC).

Baseline scenario of agreed adjustment programme foresees a sharp output contraction in 2013-2014, followed by a modest rebound in 2015-2016

The short- and medium-term risks and challenges facing the domestic economy were a focal point of discussion during our recent meetings in Cyprus, especially in view of the forced downsizing and restructuring of the baking system as well as the fiscal conditionality of the agreed bailout programme. As regards the potential channels of domestic macro adjustment, most of our discussants pointed to downside risks surrounding the troika's updated baseline macro scenario.[7] Most importantly, the bail-in of unsecured depositors in the resolution and restructuring of CBP and BoC are expected to cause considerable loss of wealth and impair business and consumer confidence, with profound implications for consumption and investment decisions. Moreover, the imposition of capital controls for an unforeseen period of time will severely disrupt economic activity both directly and indirectly, depriving liquidity from the market and risking negative spillover effects in key sectors of the domestic economy, including the all-important export oriented business services.

On top of all these, the fiscal austerity measures are likely to exert a contractionary impact on the domestic economy, at least in the short-term. As part of the conditionality underlying the agreed bailout package, Cypriot authorities committed to implement new fiscal measures worth 4.5ppts-of-GDP over the medium-term, with the aim to facilitate fulfilment of the 4%-of-GDP primary surplus target by 2018. These measures are over and above these envisaged in the November 2012 draft MoU *i.e.,* measures worth 7¼-of-GDP, out of which ca 4.5ppts-of-GDP have been legislated by the Cypriot Parliament in December 2012. Our understanding is that the troika's new baseline macro scenario for Cyprus assumes an average fiscal multiplier in the vicinity of 1.0 in estimating the short-term contractionary impact of the agreed fiscal programme. Yes, as experienced in other recent bailout cases (e.g. Greece), this assumption may well prove conservative, especially taking into account the unique features of the Cypriot crisis.[8]

[3] In June 2012, Cyprus formally requested financial assistance from the EU and the IMF.
[4] Including a State capital injection of €1.9bn to Cyprus Popular Bank (CPB) in June 2012.
[5] Further analysis on the conditions prevailing in the Cypriot economy in the period leading to the 25 March 2013 Eurogroup agreement can be found in: (i) "Final deal on Cyprus rescue package still pending", Eurobank Research, 24 January 2013 (http://www.eurobank.gr/Uploads/Reports/New%20EuropeFocus%20CYPRUS%20Jan2013.pdf); and (ii) "Trip notes Cyprus, 28-29 January 2013", Eurobank Research, 1 February 2013 (http://www.eurobank.gr/Uploads/Reports/CYPRUFeb2013v125.pdf).
[6] See "Assessment of the public debt sustainability of Cyprus", European Commission, 9 April 2013. The number reflects only those banking institutions supervised by the Central Bank of Cyprus.
[7] Troika's updated baseline macro scenario for Cyprus forecasts a cumulative real GDP contraction of 12.5ppts in 2013-2014, with a switch to positive growth rates envisaged thereafter (+1.1% in 2015, +1.9% in 2016). See European Commission's "Assessment of the public debt sustainability of Cyprus", 9 April 2013.
[8] As noted in a recent IMF report (World Economic Outlook October 2012), informal evidence suggests that the fiscal multipliers implicitly used to generate growth forecasts for 28 economies since the start of Great Recession were about 0.5. However, the IMF admits that these multiplier estimates were probably too low, by 0.4 to 1.2, depending on the forecast source and the specifics of the estimation approach, meaning that actual multipliers may be higher, in the range of 0.9 to 1.7.

In view of all these, a crucial question arising in this trajectory is when and in what shape the Cypriot economy will emerge from the present recession? In addition, what could be the drivers of medium-term economic growth, especially as the recent dramatic events dealt a serious blow to the all-important domestic financial sector?

Before attempting to address the above questions, we note that an unprecedented level of uncertainty currently exists among professional forecasters and policy makers as regards the short-term outlook of the Cypriot economy. Indicatively, Cyprus's new finance minster Harris Georgiadis said recently that real GDP may decline by as much as 13% this year, while University of Nicosia's revised baseline scenario now projects a real GDP contraction (excluding VAT and import duties) of 14.4% in 2013.[9] Notwithstanding the wide dispersion of views, most of our contacts appeared to concur with the view that the domestic macro trajectory may prove a more V-shaped one relative to the troika's updated baseline macro scenario.

As regards the short-term outlook, a number of our discussants pointed out that, in contrast to *e.g.* the Greek experience, domestic prices in Cyprus have already started to adjust rapidly to the deepening recessionary environment. Among others, domestic companies offering a wide array of retail services and, even, small retail establishments have already began to offer substantial discounts to their clients. Furthermore, domestic electricity prices have been cut by 5.75% as of 1 April 2013, with the government now planning an additional 3% decrease to take effect in the first half of May.[10] These developments provide some comfort that the domestic disinflation process may evolve more rapidly than assumed earlier, speeding up the internal devaluation process and extending some support to real disposable incomes.

Additional factors that could somewhat alleviate the domestic recession include, among others, tourism and the business services sector. Some analysis on the outlook of these sectors is provided in the next two sections, but, as a prelude, we note that **(i)** advance bookings and other relevant information suggest that tourism revenue this year may be higher than in 2012; and **(ii)** the feedback we got from a number of foreign contacts is that there are still compelling arguments favoring Cyprus's status as an important regional business services hub. For a more medium-term perspective, natural gas exports and related infrastructural investment could significantly boost potential output growth, which is assumed by the troika's new baseline scenario to be no higher than 2% in the post-crisis period.[11] Last but not least, a faster mobilization of EU funds could provide an additional pillar of support for the domestic economy in the present difficult trajectory.

On the latter issue, we note that European Commission Strategic Report on the implementation of 2007-2013 Cohesion Policy programs concludes that the EU funds absorption rate in Cyprus is lower than the average of the EU member states. As of the end of January 2013, Cyprus had absorbed €243.1mn out of a total amount of €612.4mn earmarked for the country in the period 2007-2013, bringing its total absorption rate to 39.7%. This compares with an EU average of 42.4%.[12].

All in all, an unprecedented degree of uncertainty presently surrounds the short- and medium-term outlook of the domestic economy, especially given the quite unique features of the Cypriot crisis. Yet, it appears that the ensuing recession is likely to prove a more V-shaped one relative to the troika's updated macro projections as well as that experienced in other crisis-hit countries in the euro area periphery (e.g. Greece). For an updated simulation exercise on Cyprus's GDP growth we published recently, please see *Eurobank Research "A Simulation Exercise for GDP in 2013 and 2014", April 24, 2013.*[13]

[9]http://media.philenews.com/PDF/GDP_AND_UNEMPLOYMENT.pdf
[10]http://www.capital.gr/News.asp?id=1760329
[11]This forecast does not incorporate the potential benefits ensuing for natural gas exploration.
[12]Member states must absorb 100% of the cohesion funds available to them by the end of 2015
[13] http://www.eurobank.gr/Uploads/Reports/Focus%20CYPRUSApril24_w20132.pdf

The aftermath of the Cypriot banking crisis: An economic and business model in need of restructuring

In this section we provide some background on the development model of the Cypriot economy and its role as an important business and investment hub in the run up to the domestic banking crisis.

Over the last decade, the domestic services sector has been a key pillar of the country's economic development model. In 2012, services represented around 82.3% of total gross value added (GVA), while industry (including construction) accounted for 15.4% and agriculture for just 2.3%. Cyprus emerged as an international hub for financial, logistics, offshore and other business activities even before its EU accession in 2004. Financial intermediation in particular (9.2% of total GVA in 2012) has played a prominent role in the domestic economy, acting as a locomotive for the development of a cluster of diverse and interacting business activities and services. These included, among others, real estate (11.6% of GVA), transportation & communication (9% of GVA) as well as a range of professional services such as accounting, actuarial, legal & support services (7.4% of GVA) (Figure 2- Annex).

A key question of vital importance for the Cypriot economy in the current trajectory is in what form the (once vibrant) domestic services sector will emerge from the ongoing aggressive downsizing of the banking system, the imposition of capital controls as well as the reputation and confidence trauma inflicted by the bail-in of unsecured depositors in the resolution of the Cyprus Popular Bank (CPB) and the recapitalization of the Bank of Cyprus (BoC).

Notwithstanding the *potentially* profound macroeconomic implications of the recent dramatic developments, the views expressed by a number of foreign business contacts during our meetings in Cyprus provide some comfort as regards the medium-term prospects of the domestic services sector. By and large, the majority of our discussants believe that many foreign clients who have been using a range of domestic business services to conduct their international operations will not stop relying on these services. On the contrary, it appears that there are still some compelling arguments favoring Cyprus's status as an important business services hub.

First, the high caliber and expertise of domestic professionals (lowers, accountant and others) and their established client relationships are strong disincentives for non-residents to move their businesses outside the island. Secondly, the Cypriot taxation system is still perceived as predictable and friendly, even following the 2.5ppts increase in the corporate tax-rate to 12.5%, in line with the conditionality underlying the bailout package agreed at the 25 March 2013 Eurogoup. Third, the island is still considered as politically stable and more business friendly than the country of origin for the vast majority of non-resident clients.

Tourism is another important export-oriented sector of the Cypriot economy, both in terms of value added and employment. Despite their declining share in total output in recent years, tourism revenues amounted to a *still sizeable* 10.8%-of-GDP in 2012. The transformation of Cyprus to an international business and investment hub has diverted attention from a number of important challenges facing the domestic tourism industry, including structural rigidities and red tape as well as declining cost and price competitiveness. Looking beyond the profound short-term implications of the banking sector upheaval, most of our contacts appear to believe that the current crisis presents an opportunity to fix the business model of domestic tourism industry, by placing emphasis on price competiveness, the development of niche markets (e.g. medical tourism), the construction of luxury yacht marines and the licensing of a casino. These could provide a strong impetus to medium-term economic growth, as the tourism industry retains a sizeable GDP contribution, with a strong multiplier impact on a number of important sectors of the domestic economy.

A transition from a business services hub to an important hydrocarbons exploration center?

The prospect of hydrocarbon resources exploration in Cyprus's Exclusive Economic Zone (EEZ) and the potential benefits for the domestic economy were a focal point in our discussions with industry experts. The process of hydrocarbon explorations is currently in a developing phase. The first natural gas discovery was announced in December 2011, following the granting of a concession agreement to Noble Energy Inc. to explore Block 12 of the Cypriot EEZ Exclusive Economic Zone (EEZ). Noble Energy reported significant natural gas findings to the tune of 5-8 trillion cubic feet (tcf) with a gross mean of 7tcf (see Figure 3 at the Annex section).

While identified in the first drilling, these gas reserves are not precisely determined and fully mapped and thus, they are not formally considered as recoverable yet. Under the production sharing agreement signed with the Cypriot Government, Noble Energy is about to conduct a 2nd (confirmatory) drilling in Block 12 sometime between June and July 2013. The new findings from the collected geological data should clear out most uncertainties regarding the natural gas content of Block 12.

Natural gas exploration efforts are not limited to Block 12. In January 2013, the government signed contracts with the ENI/KOGAS consortium for hydrocarbons exploration in Blocks 2, 3 and 9. The first indications from Block 9 point to a bigger reserve than that of Block 12. The government also signed in early February hydrocarbon exploration contracts for Blocks 10 and 11 with French TOTAL. The aforementioned contracts involve exploration related investments on behalf of the companies to the tune of $2bn plus the licensing fees.

The U.S. geological survey data shows that the Levantine Basin, the easternmost part of the Mediterranean Sea, may contain up to 122tcf of natural gas. Based on these geological data, KRETYK (Cyprus National Hydrocarbons Company) estimates that gas reserves within the Cypriot EEZ could amount up to 60tcf or 1.7 trillion cubic meters (tcm), an amount close to the proven gas reservoirs of Azerbaijan (2.5 tcm).

According to preliminary KRETYK estimates, the six blocks out of the thirteen auctioned thus far (*i.e.,* Blocks 2, 3, 9, 10, 11, 12) may contain a total of 40tcf, which may well translate into total proceeds of around €400bn within a time horizon spanning 2½ years (Figure 3). Under the assumption of a 25% Cypriot share in total proceeds, as part of the future revenue-sharing agreements with the energy companies, the government direct revenues could average €4bn per year.

Yet, in order for gas reservoirs to become an important source of revenue, significant infrastructure investments will be required. For the time being, there is no final agreement as regards the transportation of gas resources. A plan developed under the previous Cypriot administration foresaw the transportation of gas resources with LNG carriers-ships designed for transporting liquefied natural gas (LNG). A huge advantage of LNG relative to pipeline gas is that the former can be exported to any market around the world. In addition, LNG transportation makes the country less dependent on pipeline networks for transportation.

However, the construction of a gas pipeline to the coast and a liquefied natural gas (LNG) plant plus other gas facilities in the Vasilikos area on the southern coast would cost approximately €10-12 bn. According to KRETYK, a final decision as regards the construction of a liquefaction plant is unlikely before the beginning of 2015, which means that the operation of such a plant can begin no earlier than 2019-2020.

The energy sector represents a new and lucrative opportunity for the country. The benefits from gas exploitation are not limited to licensing fees, direct sales revenue and related investments but can also span the whole economy due to positive spillover effects. Moreover, transforming Cyprus to an important offshore energy hub will help the country accumulate more geopolitical power within the broader region.

Domestic banking-sector resolution and restructuring process underway

The ongoing aggressive restructuring and downsizing of the domestic banking system was at the epicenter of our discussions during our recent trip to Cyprus. The agreed adjustment program calls for a comprehensive resolution and restructuring of the two biggest domestic lenders, Cyprus Popular Bank (CPB) and Bank of Cyprus (BoC), via a bail-in scheme from uninsured depositors and junior bondholders. Based on the legislation adopted by the Cypriot Parliament on 22 March 2013, Central Bank of Cyprus (CBC) is established as the single resolution authority for banks and cooperative credit institutions. Making use of this legislation, CBC proceeded with a number of actions that have already reduced the size of the domestic banking sector to 350%-of-GDP from 550%-of-GDP previously. These include:

- **The carve-out of Greek operations of three Cypriot banks (CPB, BoC and Hellenic Bank**). Greece's Piraeus Bank acquired these branches, which, according to the PIMCO's adverse scenario, had a total of €16.4bn in assets and €15bn in liabilities.

- **The resolution of CPB:** The bank will be split into a good and bad bank. The bad bank will assume CPB's uninsured deposits and non-performing assets and will be gradually resolved. The good part will assumed CPB's performing assets at fair value, the insured deposits and the bank's ELA exposure at nominal value (estimated at ca €9bn according to press reports). The good part will be folded into the recapitalized Bank of Cyprus.
- **The recapitalization of Bank of Cyprus** through a debt to equity conversion to reach a core tier one ratio 9% under the adverse scenario of PIMCO by the end of the programme period. 37.5% of deposits exceeding €100,000 will be converted into "class A" shares with full voting and dividend rights, with an additional 22.5% being held as a buffer for possible conversion in the future. Another 30% will be temporarily frozen. An independent and updated valuation of the capital needs will be completed by the end of June 2013.Note that the precise losses of uninsured CPB and BoC depositors have not yet be determined.

Focus - Sovereign borrowing needs & funding sources over the programme period (and beyond)

This section constitutes an excerpt from our recent report on the future evolution of Cyprus's public borrowing needs and sources of funding.[14]

External financial assistance to Cyprus (henceforth, programme funding) under the bailout package agreed at the 16 March 2013 Eurogroup, and later reconfirmed by the Eurogroup meeting of 25 March 2013, amounts up to €10bn. The latter will be disbursed over a 3-year period, stretching from Q2 2013 to Q1 2016, subject to the fulfillment of certain quantitative programme targets and structural benchmarks. Additional funding (of around €13bn) will be secured by a range of burden-sharing measures adopted by the Cypriot side (Table 1). As a result, total financing under the agreed programme will amount to around €23bn compared to an estimated €17.5bn implied by the underlying assumptions of the November 2012 draft MoU.

The increase in the required sovereign funding to cover the projected borrowing gap over the programme period is mainly the result of the worsened domestic macroeconomic environment and the assumption of a more gradual adjustment in the primary balance relative to prior expectations. According to a provisional assessment of Cypriot public debt sustainability that was released in early April 2013[15], real GDP losses in 2013-2014 are expected to amount to 12.6ppts vs. 4.8ppts in the November 2012 draft MoU, while the general government primary balance is now expected to reach the 4%-of-GDP target no earlier than in FY-2018 compared to FY-2016 previously.

Despite the higher-than-earlier-expected funding needs over the programme period, the new troika baseline scenario forecasts a peak in the debt ratio in FY-2014 to 126.3%-of-GDP compared to a peak of 142.7%-of-GDP envisaged in the November 2012 draft MoU.[16] That is because the programme agreed at the 25 March 2013 Eurogroup incorporates a much larger financing contribution from the Cypriot side i.e., around €13bn compared to ca €1.2bn (via the bail-in of junior bank bondholders) assumed in the November 2012 MoU. In what follows, we take a closer look at the evolution of the Cypriot general government borrowing needs and sources of funding over the programme period and beyond, drawing on the latest European Commission assessment (April 2013).

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[14] Eurobank Research *"Focus Notes Cyprus - Sovereign borrowing needs and sources and sources of funding over the programme period (and beyond)"*, 18 April 2013.
http://www.eurobank.gr/Uploads/Reports/New%20Europe%20-Cyprus%20April%2018%202013.pdf

[15] European Commission, "Assessment of the public debt sustainability of Cyprus", provisional draft, 9 April 2013.

[16]For a detailed analysis on the projected evolution of the Cypriot public debt ratio please see Eurobank Research *"Cyprus sovereign solvency outlook"*, April 22, 2013.
http://www.eurobank.gr/Uploads/Reports/New%20Europe%20Cyprus%20April%2022%202013.pdf

Table 1 – Sources of sovereign funding over the programme period (EUR bn)

Contribution by Cyrpus	**13.3**
bail-in of junior bondholders & uninsured depositors (CBP & BoC)	10.6
Additional taxes (increases in corporate income tax, taxes on capital income & levy on deposits)	0.6
Gold sales 1/	0.4
Roll-over of marketable debt held by domestic investors	1.0
Privatization	0.6
Change in terms of outstanding Russian loan 2/	0.1
Programme funding	**10.0**
EFSF	9.0
IMF	1.0
Total financing	**23.3**

Source: european Commission (April 2013)

1/ subject to principle of central bank independence & provided that such profit allocation is in line with CBC rules and does not undermine the CBC duties under the Treaties and the Statue

2/ culculation implies that the Russian Federation will grand certain concessions to the outstanding €2.5bn loan provided to Cyprus in late 2011

Sovereign funding gap and sources of funding

Table 1.1 below displays the evolution of Cyprus's general government funding need over the programme period and beyond. As per the new troika baseline scenario, the overall sovereign funding need over the period Q1 2013–Q1 2016 (after incorporating Cyprus's contributions) is estimated at ca 10bn, an amount to be covered fully by official funding earmarked under the agreed programme. The latter will take the form of up to €9bn in ESM funding (€2.5bn in a cashless transaction for the recapitalization of the domestic banking sector and €6.5bn for budgetary financing and debt redemptions) and IMF contribution of up to €1bn under a 3-year extended fund facility.[17] For the post-programme period stretching from Q2 2016 to Q4 2020, the troika's updated baseline scenario envisages a significant decline in the sovereign borrowing need to ca €4bn in cumulative terms.

As regards **financial sector recapitalization**, no programme funding will be provided for the resolution and restructuring of Cyprus Popular Bank (CPB) and Bank of Cyprus (BoC), as per the 25 March 2013 Eurogroup agreement. ***Comment:*** According to a European Commission provisional draft on the evolution of Cyprus's general government borrowing requirement and sources of funding[18], the total financing need for the recapitalization of the domestic financial sector is estimated at €11.7bn. In addition to that amount, Cyprus's adjustment programme envisages the creation of a contingency buffer of €1.1bn over the programme period, so as to cover a bigger-than-expected increase in system-wide non-performing loans (NPLs) and/or the recapitalization need of Hellenic Bank, in case the latter can not be achieved fully via private sources. As per the baseline scenario underlying Cyprus's draft adjustment programme, the aforementioned amounts will be covered by the bailing in of junior bank bondholders and unsecured depositors in the resolution and restructuring of CPB and BoC (€10.6bn) along with programme funding (up to €2.5bn) earmarked for that purpose.[19]

[16] The IMF has already signaled its intention to participate in the Cypriot bailout under the "normal access procedure".
[17] European Commission, "Assessment of the actual or potential financing needs of Cyprus"; provisional draft, 9 April 2013.
[18] As noted in the 9 April 2013 EC draft report on Cyprus's financing needs, the €1.9bn bond issued by the government in June 2012 to recapitalize CPB will **not** be replaced by an ESM bond and thus, it is not incorporated in the estimates and projections of Tables 1.1 and 1.2.

Table 1.1 – Sovereign funding needs

In EURmn	Programme period (Q2 2013 - Q1 2016)*	Beyond programme period (Q2 2016 - Q4 2020)*
I. Amortization of outstanding market debt excl. short-term (I.1 + I.2 + I.3 + I.4 + I.5)	**4,119.81**	**3,642.28**
I.1 medium & long-term bonds	4,766.46	1,471.02
I.2 loans (*I.2.1 + I.2.2 + I.2.3*)	263.94	2,076.26
I.2.1 foreign loans (excl. Russia)	136.84	300.60
I.2.2 Russian loan	0.00	1,500.00
I.2.3 domestic loans	127.10	275.68
i.3 local government loans	60.00	95.00
I.4 saving certificates	29.37	0.00
I.5 bond roll-over by domestic investors	-1,000.00	0.00
II. Amortization of new market debt	**0.00**	**259.75**
III. Amortization of official loans (III.1 + III.2)	**0.00**	**335.66**
III.1 ESM	0.00	0.00
III.2 IMF	0.00	335.66
IV. Financial sector recapitalization (IV.1 + IV.2 + IV.3)	**2,500.00**	**0.00**
IV.1 total recapitalization need	11,700.00	0.00
IV.2 debt-equity swap for uninsured BoC deposits & CPB resolution	-10,300.00	0.00
IV.3 contingency buffer	1,100.00	0.00
V. Fiscal financing need (V.1 + V.2 + V.3 + V.4)	**3,360.94**	**-186.00**
V.1 primary balace	1,266.82	-2,979.04
V.2 interest payments	1,794.34	3,108.04
V.3 one-off measures/1	400.00	0.00
V.4 below the line items (*V.4.1 + V.4.2 + V.4.3 + V.4.4*)	-100.20	-315.00
V.4.1 privatization revenue	-625.00	-775.00
V.4.2 ESM & EIB capital contributions	99.80	0.00
V.4.3 called guarantees	549.00	0.00
V.4.4 future CB profits	-400.00	0.00
V.4.5 capitalised interest on CPB bond/2	276.00	460.00
Net financing needs (I + II + III + IV + V)	**9,980.66**	**4,051.39**

Source: European Commission (April 2013)
1/ include compensation for provident & retirement funds in CBP to ensure equal treatment with such funds in BoC following the conversion of deposits into equity.
2/ The statistical treatment of the CPB recapitalization bond is currently under assessment by Eurostat
(*) positive entries corespond to

As regards **amortizations of medium- and long-term public debt**, some €4.7bn of outstanding medium- and long-term government bonds mature over the programme period (Table 1.1, line I.1). Out of these, ca €3bn correspond to foreign-law bonds (EMTNs) and the rest to local-law bonds (GRDS). The first EMTN redemption falls due in June 2013 (€1.4bn), while the first GRDS maturity comes in July 2013 (€0.7bn). Official funding earmarked for Cyprus in the context of the agreed programme will cover ca €3.7bn of the total amount needed to redeem medium- and long-term government bonds, while the remaining €1bn will be secured by the rolling-over of an equiproportional notional amount of GRDS currently held by domestic investors (Table 1.1, line I.5). ***Comment:*** With the exemption of the latter amount (€1bn), the remainder of the required funding to cover total medium- and long-term debt amortizations (ca €4.1bn) will be provided by the official sector in the context of the programme envelope agreed at the 25 March 2013 Eurogroup. As regards short-term sovereign debt issuance, (not shown in Table 1.1), our expectation is that the outstanding stock of T-bills (currently at ca €1bn) will increase further during the programme period, reaching as much as €2bn.[20] The implication of such a development would be to secure additional financing over the programme period, however to the cost of some further crowding out of private investment.

[20] This is especially if, as we expect, the ECB decides at some point to start accepting Cypriot sovereign debt instruments as collateral in its open market operations, subject to the signature of the MoU and despite Cyprus's insufficient credit ratings

With respect to **budgetary financing**, some €3.4bn of programme funding has been earmarked for covering fully the corresponding funding need over the programme period (Table 1.2). That is, provided that the general government primary balance will evolve broadly in line with the projections of the new troika baseline scenario (1).

Table 1.2 – Allocation of official-sector financing over programme period (EUR bn)

Debt redemptions	up to €4.1bn
Budgetary financing	up to €3.4bn
Financial sector recapitalization	up to €2.5bn
Total programme funding	**up to €10bn**

Source: European Commission (April 2013)

Note that as part of the conditionality underlying the new draft MoU that was liked to the press in early April[1], additional fiscal measures worth 4.5ppts-of-GDP will need to be implemented over the medium-term so as to facilitate fulfillment of the 4%-of-GDP primary surplus target by 2018. These measures are over and above these envisaged in the November 2012 draft MoU (i.e., measures worth 7¼ppts-of-GDP out of which ca 5ppts-of-GDP have been legislated in December 2012).

Concluding remarks

The financing programme for Cyprus agreed at the 25 March 2013 Eurogroup aims to provide full coverage of the general government borrowing need over the period Q2 2013 to Q1 2016, provided that the domestic economy and the government's fiscal position will evolve broadly in line with the troika's revised baseline scenario.

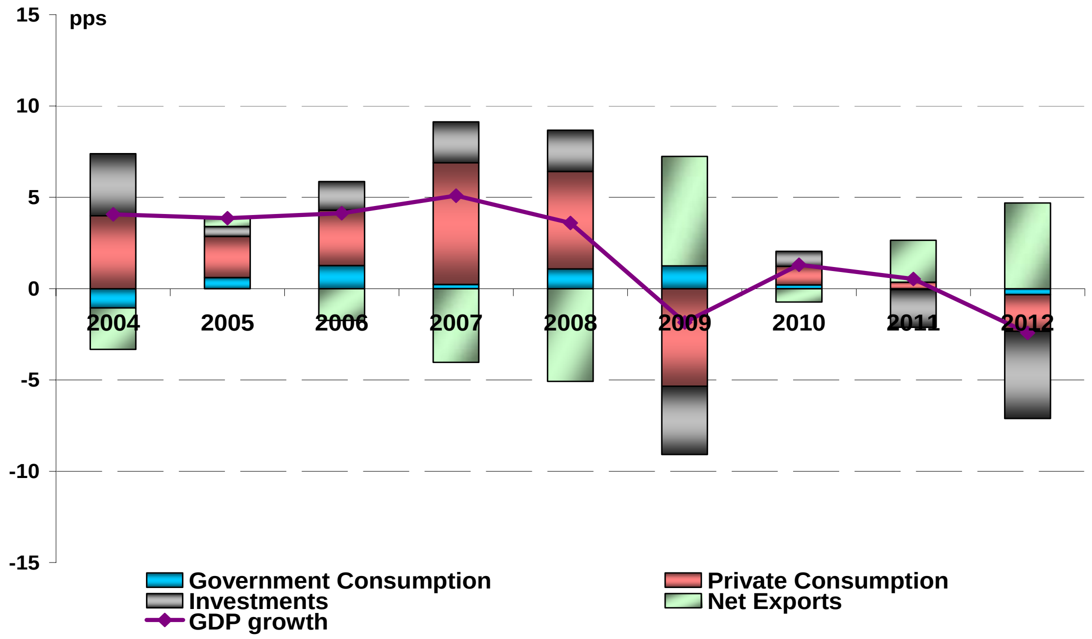
Under the new baseline scenario, the general government's borrowing need is expected to decline substantially in the post-programme period Q2 2016 – Q4 2020, cumulatively amounting to ca €4bn or slightly over 4%-of-2012 GDP.

Any deviation from the agreed fiscal targets due to e.g. a deeper-than-expected output contraction in 2013-2014, a higher than assumed fiscal multiplier and/or lower-than-projected privatization revenue will probably need to be covered by domestic sources.

From a longer-term perspective, the underlying assumptions of the revised troika baseline scenario (e.g. medium-term real GDP growth of ca 2%/annum and a 4%-of-GDP primary surplus) seem broadly realistic, especially given expected revenues from natural gas exports and the positive growth impact of related infrastructural investment.

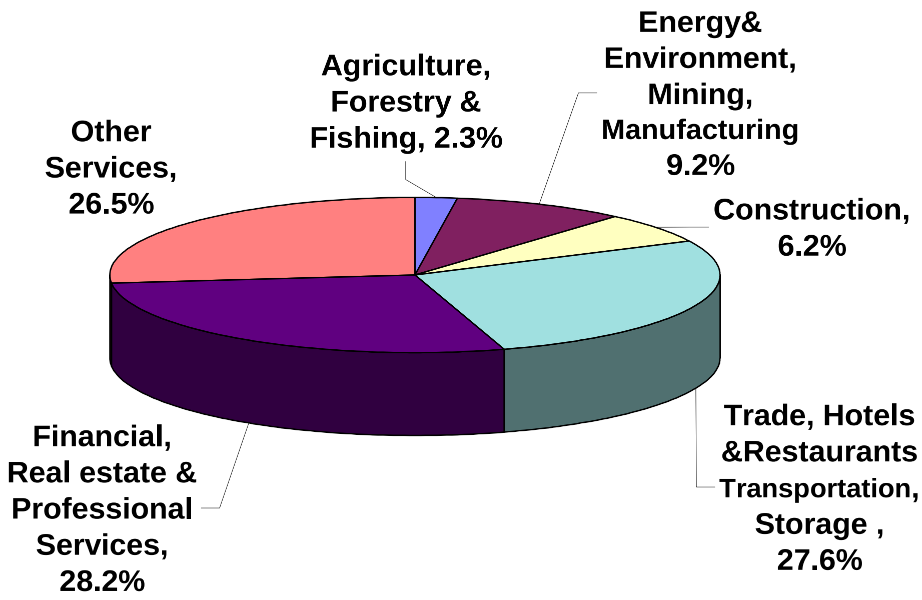
Annex

Figure 1: Domestic demand-driven growth model challenged in the post global crisis era



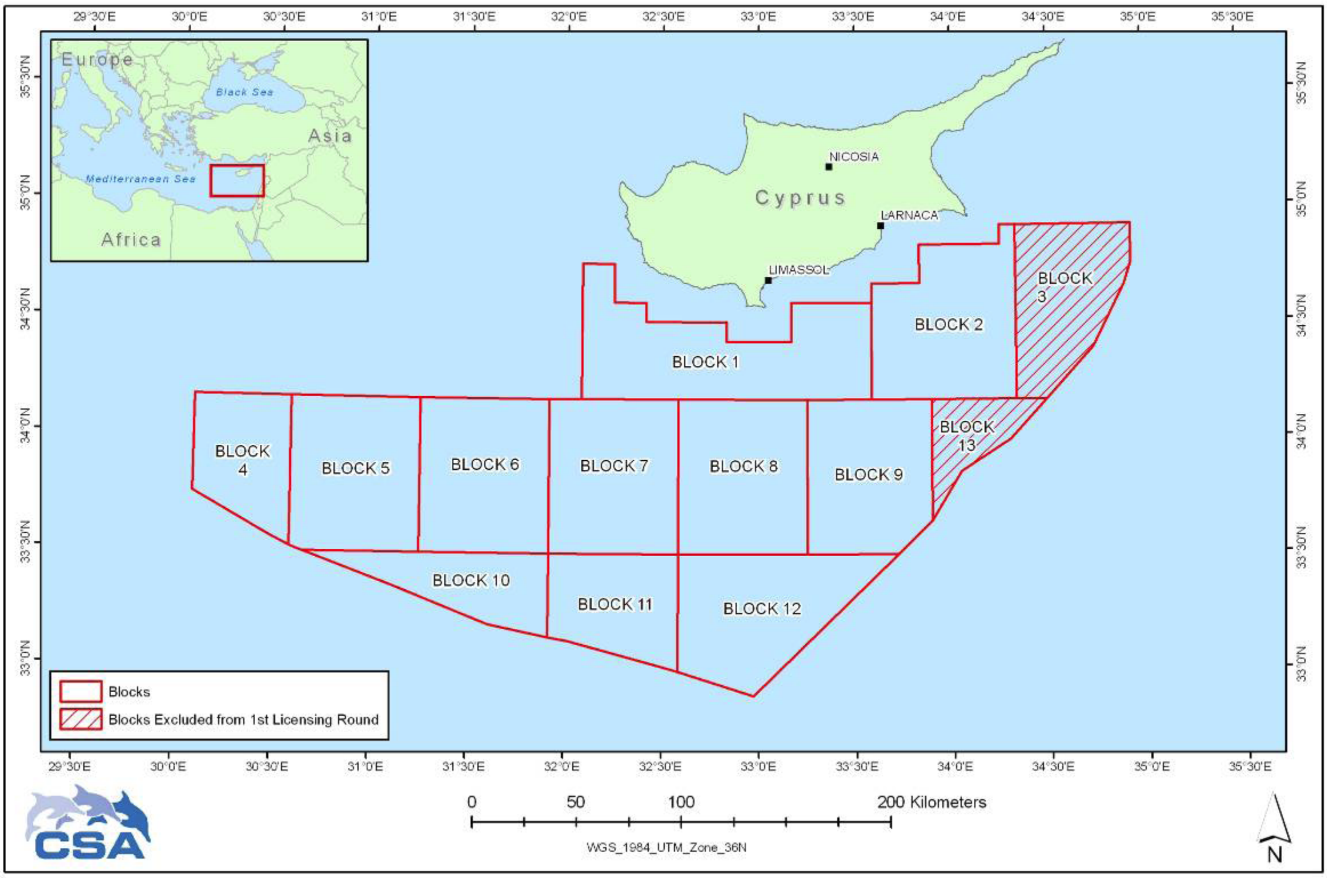
Source: National Statistics, Eurobank Research

Figure 2: Structure of Gross Value Added



Source: National Statistics, Eurobank Research

Figure 3: Map of hydrocarbon exploration fields



Source: Cyprus Shipping Association, Ministry of Energy & Industry of Cyprus Republic, KRETYK

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