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Programme Implementation on a Good Start; Revised GDP Forecasts

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- The implementation of the adjustment programme of Cyprus in the first months has started on a good foot; Long term prospects have also improved significantly
- Recession will most probably turn out to be less front-loaded than consensus and official forecasts suggested in 2013; yet the cumulative output adjustment is anticipated to remain unchanged in 2013-2015
- The stabilization of the financial sector is under way after the exit of Bank of Cyprus from resolution status and the gradual relaxation of capital controls
- Even though the confirmation drilling results in Block 12 may have undershoot initial findings, they will not fundamentally change the government strategy in hydrocarbons exploration

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1. Overview and Latest Developments

This Report assesses the progress of the first months of the implementation of the Adjustment Programme of Cyprus and how the economy responds to the shock of the dramatic decisions of last March. An update to the GDP outlook for 2013 and 2014 is also offered. The report follows from a visit to Cyprus we had in the last days of September. In that, we had the opportunity to meet with prominent officials from, inter alia, the Central Bank of Cyprus, The Ministry of Finance, the IMF, Business Unions and banks.

As a general comment, Programme implementation is on a good start; structural and fiscal targets have been met so far; in fact, fiscal intra-year targets have been outperformed up to date and some officials express optimism that the total fiscal deficit for 2013 will be limited to 5% of GDP against a 6.5% projected in the MoU. Government ownership of the Programme has greatly improved; anti-European voices have subsided, albeit privatizations still meet objections. Stabilization of the financial sector is under way after the exit of Bank of Cyprus from resolution status. In addition, some partial relaxation of capital controls has already been successfully implemented as the first of four phases of a pre-agreed roadmap to a complete lifting of restrictions. Still, a full lifting is a complex exercise and cannot be done rapidly or there is a risk of negative developments undermining confidence. In any case, conducting of business does not suffer that much from capital controls as from a liquidity squeeze. Lending rates to businesses are at the vicinity of 7-8%; credit expansion has become mildly negative but with NPLs at a rising path, securing a new loan is a challenging task even for healthy businesses; foreign suppliers do not accept guarantee letters from Cypriot banks.

Economic prospects for 2013 are significantly improved compared to initial expectations as the recession in 2013 will most likely be less deep than what projected in the Programme. The economy shows signs of flexibility; wages and prices are adjusting downwards, thereby accelerating implementation of internal devaluation. Wages in the private sector have reportedly fallen at cases by 10-20% and the public sector follows suit with declines of 5-7%; HICP has approached zero in August. Real estate prices have also fallen by more than 15%, with further declines expected (estimates for the cumulative decline expected vary from 18% to 33% from peak).

The milder than previously expected recession in 2013 may, to some extent, be related to utilization of deposits on behalf of households in order to support previous levels of well-being. Hence, it is possible that in 2014 consumption decline will correspond more fully to disposable incomes declines and recession may be deeper than expectations. In particular, our revised forecast, which takes into account the expected impact of the latest specification of agreed measures, as well as trends in first months of 2013, estimates real growth at -7.4% for 2013 and at -6.1% for 2014. While the hope for a recovery more V-shaped than that envisaged in the Programme is not gaining ground, we still expect the size of the cumulative loss of GDP to remain at the projected range (13-16%). Another point of worry is the acute rise in the unemployment rate, which currently stands above 17%, from 11.7% a year ago, the highest y-o-y change in the Eurozone. This aspect underlines the need for strengthening the safety net for the most vulnerable.

This period is also marked by the expression by President Anastasiades of his intention to revive unity talks as one way forward to boost growth. Although the intention is genuine, the Cypriot problem is very complicated and success in unity talks relies upon many more factors than the government's intentions. Hence, in the short-term, restoring liquidity and confidence in the banking system is a more tractable way of co-ordinating expectations on a good equilibrium.

Still, longer-run prospects are improving. After an initial period of dismay and anger, many foreign investors are now reconsidering their intention to leave Cyprus. Many factors, including a simple and transparent legal framework, favourable tax rates, efficient public administration, good infrastructure and quality of life, quality services and educated labour force, motivate a decision for many firms to expedite international business from a Cypriot basis even if they scale down liquidity maintained in the country. Hence, there is hope that the business services sector can reclaim its dynamism. The other two pillars of Cypriot growth have also received a positive boost; a good tourist season, benefiting from an increase in the number of Russian tourists, points to upholding of revenues at the satisfactory 2012 levels; as for hydrocarbons explorations, results of the first confirmatory drill of the Area 12 gas reserves are being processed and a second drill will be planned for early 2014; the solution of liquidification and sea transport seems to be elected for exporting gas.

2. GDP Outlook for 2013 and 2014

This section offers an update to Cyprus' GDP outlook for 2013-2014 and associated risks to account for recent developments described above. The first months of implementation of the

Table 1
Eurobank Baseline Macroeconomic Projections 2013-2014

	2012 €bn, Nominal	**Shares in 2012 GDP**	**2013 %yoy growth, Real**	**2014 %yoy growth, Real**
Private Consumption	11.948,1	66,8%	-9,0%	-9,8%
Government Consumption	3.587,9	20,1%	-8,9%	-3,6%
Total Consumption	15.536,0	86,9%	-9,0%	-8,9%
Gross Fixed Capital Formation	2.294,8	12,8%	-31,0%	-13,4%
Domestic demand	17.876,9	99,9%	-11,9%	-9,9%
Exports	8.136,7	45,5%	-5,9%	-5,6%
Imports	8.126,8	45,4%	-15,8%	-11,8%
Real GDP	**17.886,8**		**-7,4%**	**-6,1%**
GDP deflator			1.5%	0%
Unemployment			18%	22%

Source: Eurobank Research

Adjustment Programme of Cyprus following Euro group decision agreements on March 16 and 25 and the serious blow which those inflicted to the all-important domestic financial sector have a profound effect on the structure of the Cypriot economy and the level of economic activity. Despite some early signs that the economy is showing flexibility in adjusting in new conditions, the medium-term outlook remains bleak. GDP contraction in 2013 is now expected to be less deep but 2014 GDP is projected to contract more than initial projections.

The projection for total growth is extracted from a quantification of trends in components of GDP, with economic rationale invoked for each. Given the extraordinary nature of developments facing the Cypriot economy, unconventional methodologies had to be utilized to reach a forecast. For this reason, the forecast remains subject to unusual risks as the MoU between Cypriot authorities and official lenders is continuously re-detailed and data availability is low. Under the main scenario, which takes into account the expected impact of the latest specification of agreed measures, as well as trends in first months of 2013, real growth is estimated at -7.4% for 2013 and at -6.1% for 2014 (Table 1).

2.1 Recession deepened less than anticipated in Q2 2013; Explanations and Implications for 2013-2014 GDP Prospects

The beginning of the second quarter was marked by the dramatic events of last March. Hence, the GDP outcome was anxiously expected as a first indication of the impact of the turmoil caused by the bail-in and associated measures (the imposition of capital controls in particular) on the level of economic activity. Official results revealed that real GDP contracted by 5.7% yoy in Q2-2013, accelerating from -4.9% yoy in Q1-2013 and -3.5% yoy in Q4-2012. The contraction in domestic demand stood as the main driver behind the adjustment of the economy. Domestic demand deducted a total of 11.3ppts from growth in Q2-2013. Private consumption contracted by 5.8% yoy in Q2, compared to 5.1% yoy in Q1 and -4.9% yoy in Q4-2012. Consequently, the performance of private consumption stood at -5.4% yoy in the 1H-2013. While this constitutes deterioration in comparison to previous quarters, it is significantly below the program's full year projection of -12.4% in 2013. To the extent that final data do not feature any major revision, this outcome can rather be considered as a positive surprise. Gross fixed capital formation contracted by 26% yoy in Q2-2013 vs. 24.6% yoy in Q1-2013. The pace of contraction in gross fixed capital formation in 1H-2013 was more or less in line with the forecast of the program for the H1 2013 (-25.3% vs. -29.5%).

Negative domestic demand dynamics were partially offset by the positive contribution of net exports, which in fact increased in comparison to Q1 (5.6pps vs. 4.8pps). This reflects the combined impact of a sharper contraction in imports and a milder decline in exports. Imports declined by 19.7% yoy in Q2, down from 14.3% in Q1, mirroring negative domestic demand dynamics. In contrast, exports declined by 5.7% yoy in Q2 vs. 3.1% yoy in Q1, primarily reflecting lower receipts from the services sectors in that period.

The lower than expected recession in the second quarter has spurred expectations among policy makers and market agents that full year recession will undershoot the official program baseline forecast of -8.7% in 2013; some of our discussants in our recent trip even projected that GDP contraction will be contained below 7%. The main driver of this outperformance over expectations is the fact that private consumption seems to adjust slower than the projections of the program. Partly, this is due to the fact that negative developments were expected already from 2012. Hence, households reduced their consumption as a precautionary measure already from 2012, thereby moving forward some part of the foreseen recession. However, to some extent this can also be attributed to an effort by households to use their precautionary savings in the banks in order to smooth their consumption and sustain their past way of living. It seems that some parts of the population hope that the shock in their well-being is temporary, i.e. that it does not affect their permanent income. This interpretation is corroborated by the fact that the fall in private consumption was less than proportional than the fall in gross disposable income. According to Eurostat, gross disposable income in Cyprus fell by 6.7% and 6.6% yoy in Q1 and Q2 2013 respectively, compared to a 5.4% fall in private consumption in H1 2013, i.e. only 81% of the percentage fall in incomes. However, this interpretation implies that when all households realize that the shock in their incomes is permanent, the fall in private consumption will rise to –at least- the full percentage of the tantamount of incomes'.

Another reason for the containment of recession is the fact that imports fall much more aggressively than consumption. This partly reflects the collapse of investment and the associated decline in the demand for intermediate investment goods; this trend will be mediated in 2014, when the fall in GFCF is expected to be milder. Yet, the collapse in imports may also indicate a change in the composition of the consumer's basket against imported goods.

As a combined result of aforementioned impacts, there is scope that the recession in 2014 will be deeper than that envisaged in program projections. In fact, the expectation of a deeper-than-projected recession in 2014 was widespread among many policymakers and market agents we interviewed. Still, the cumulative output contraction is widely anticipated to remain

within the range projected by the program, i.e. to approximately 13-15%.

As a reminder, the Adjustment Programme foresees a sharp output collapse in 2013-2014 and a modest rebound in 2015-2016. In particular, the MoU forecasts a real GDP contraction by -8.7% in 2013 and another -3.9% in 2014, a cumulative output loss of approximately 12.6pps. Then, a modest rebound of the economy is foreseen in 2015-2016 (1.1% and 1.9% respectively).

The quite unique features of the Cypriot crisis render the short-term outlook of the Cypriot economy subject to an unprecedented level of uncertainty. The main channel through which the Adjustment Programme can impact the domestic economy is related to the loss of wealth and impairment of business and consumer confidence by the bail-in. This is already causing profound negative consequences for private consumption and investment decisions. Furthermore, the view initially shared by many analysts that the domestic macro trajectory may prove a more V-shaped one relative to the troika's updated baseline macro scenario does not appear to be supported by recent developments. Not only consumption smoothing is now considered to be more gradual, but an understanding is being reached that capital controls cannot be lifted rapidly or a major setback in confidence will be risked. Such an eventuality would weigh negatively on the level of economic activity. The restructuring of the domestic banking sector and the capital controls imposed will disrupt economic activity, both directly and indirectly. Although domestic businesses report that the impact of restrictive measures on liquidity is manageable, the aggregate result on the level of export-oriented business services should not be underestimated. Negative spillovers in other sectors of the economy are also possible, at least in the short-term. These contractionary impacts come on top of fiscal austerity measures, with a combined harmful effect on disposable incomes and, subsequently, a feed back to growth. Also considering the rapid rise in unemployment, this highlights the need for Cypriot authorities to improve the EU funds absorption rate in Cyprus, which remains lower than the average for EU member states. These funds can have an important contribution in supporting growth and enhancing the safety net for the most vulnerable via programmes designed to increase employment, combat poverty and social exclusion, and promote training.

On the other hand, and in contrast to the Greek experience, in our recent visit we found out that prices' adjustment seems to have already started taking place. Wages in the private sector have reportedly fallen by 10-20% at cases and the public sector follows suit with declines of 5-7%. Corporations from a wide array of retail services have already responded by offering substantial discounts to their customers within a short time after the shock. As a result, HICP recorded a reading of 0.1% yoy already in August and is expected to remain subdued in the forthcoming period, thereby offering some support to real incomes and budgets. Equally importantly, a speedier reaping of internal devaluation benefits may precipitate the recovery.

2.2 Baseline Real GDP growth forecast for 2013 (-7.4%)

(a) Private consumption (66.8%of GDP): Private consumption predominantly depends on disposable income. AMECO estimates net nominal disposable income in 2012 at €15bn.

A number of strong **contractionary impacts** on economic activity and incomes operate in the Cypriot economy following the agreement with EC/IMF/ECB for an Adjustment Programme:

1. **Restructuring of the banking sector**: this major shock has both an immediate impact, as well as an impact on expected net credit growth. EC's DSA (Draft 9 April 2013) calculated pre-agreement Cyprus' domestic banking sector, including the cooperative credit institutions, at 550% of GDP or ca €98.5bn.[1] The same document also calculated that, as a result of actions undertaken for the restructuring, the Cypriot banking sector has been downsized *immediately* to 350% of GDP or ca €62.7bn.

According to Cyprus' MoU, the ratio of bank assets over GDP should be at EU average by 2017; the latter is estimated to be at 300% by then. Following MoU's forecasts, 2017 GDP should be at ca €16,6bn, hence bank assets should reach €49,9bn.

However, this projection for bank assets at 350% of GDP by the end of 2013 does not seem to be accomplished. Furthermore, reference to this target is not made in the last MoU Review; instead, focus is moving towards general restructuring and regulation of the banking sector. According to IIF,[2] bank assets of Cypriot banks in Greece (loans) in September 2012 amounted to €18,9bn and bank assets in Eastern Europe to €3,6bn. The former are already sold to Piraeus Bank but the latter are not expected to be sold this year; these measures are assumed to have no impact on Cypriot disposable incomes (latent hypothesis: no expected profits of Greek operations). Hence, bank assets of Cypriot banks are calculated at €79.6bn, while bank assets in Cyprus are calculated at €76bn. These, in theory, should be reduced by €13.3bn from the resolution of Laiki and

[1] ECB calculated bank assets in Feb 2013 at €126,4bn or 7.1 times the Cypriot GDP; the difference is due to the fact that the MoU definition only takes account of the assets of financial institutions supervised by the CBC.

[2] IIF Research Note, Cyprus: Just The Facts, 19 March 2013.

the debt-to-equity conversion of the Bank of Cyprus in order to reach €62.7bn by year end (this calculation concurs with the MoU's estimation of Cyprus' contribution in the package). However, the latest MoU Review estimates the bail-in in PBC and BOC will result in losses of deposits, senior and subordinated debt of €9.4bn. While deposits are converted into shares in the new BoC, to be conservative we assume that the respective decline in bank assets will correspond to the full amount. This constitutes a 9.4/98.5=9.5% reduction in bank assets.

This **Bail-in** of uninsured depositors will cause a loss of wealth, which will reduce private consumption and business investment. However, the wealth effect on consumption is a contradictory issue.[3] In addition, there are no reliable data as to the exact percentage of deposits that actually belong to Cypriots and to international depositors. Hence, we take the direct route to assume that a reduction in bank assets has an equiproportoniate impact on the sector's contribution to GDP. In 2012, the financial and insurance sector contributed 9.2% in Cyprus' Gross Value Added (GVA). Hence, this downsizing should deduce 9.2*0.095=0.9ppts of GDP or 1.1ppts of net nominal disposable income.

2. **Fiscal consolidation measures**. For 2013, fiscal measures of 4.8ppts of GDP are projected. Assuming an equal reduction in net nominal disposable income due to the nature of measures, a reduction of 5.7% in net nominal disposable income will accrue.

3. **Spill-overs** of banks' restructuring on related professional business services and financial services exports. Actually, many economic activities in Cyprus directly depended on the demand created by the financial sector's activities: commerce, transports, hotels and restaurants, real estate, constructions, professional, technical and supporting services, entertainment, other services. All these sectors together account for 51.8% of the Cypriot GVA (€8.4bn). Given recent trends, it seems that the transmission of banking sector downsizing to those sectors' demand is less than proportional. Hence, we assume that the reduction in bank assets in 2013 [€9.4/98.5=9.5%] generates half this percentage reduction in the contribution of those sectors to GDP; this is equivalent to say that elasticity of financial sector activity to those sectors' demand is equal to 0.5. i.e. 0.095*0.5*0.518*17.9= €0.44bn or 2.5ppts of GDP or 3ppts of net nominal disposable income.[4]

In total, net nominal disposable income is projected to decrease by 9.8%. The MoU assumes a GDP deflator of 1.9% yearly for the entire period 2013-2016. However, given the extraordinary GDP contraction and the simultaneous liberalisation of the labour market incurred by the MoU, this is too high. We pencil a GDP deflator of 1.5% for 2013 (due also to the impact of tax rate hikes) and 0% for 2014. Hence, real disposable incomes should be reduced by -11.3% in 2013.

Given the consumption smoothing we described above, we assume that the change in consumption will (continue to) be 80% of the change in disposable income for the entire 2013. Hence, real private consumption will contract in 2012 by 9% (against an EC's projection of -12.3%).

(b) Government consumption: (20.1% of GDP) we maintain the MoU projection for a -8.9% contraction.

Final consumption (86.9% of GDP): -9%

(c) Gross Fixed Capital Formation: (12.8% of GDP) Investment is the GDP component which is more sensitive to changes in the economic climate. Furthermore, Cypriot businesses face unprecedented liquidity constraints due to the banking crisis and capital controls. Taking in mind realized trends, we project a real decrease of GFCF of 31% (slightly deeper than the MoU projection for a -29.5% contraction).

Domestic demand (99.9% of GDP): -11.9% change.

(d) Exports of g&s (45.5% of GDP): Ceteris paribus, a downsizing 3.4ppts of GDP or by 5.6% of sectors representing 61% of the Cypriot economy's GVA (financial sector and sectors related to it) would result in a reduction of exports by 5.6%. With no competitiveness gains and a small decline in international demand (-0.4% contraction in EU17, sluggish growth projected for SE Europe, Cyprus' main export markets and turmoil in the area), we pencil a real reduction of exports by -5.9%.

(e) Imports of g&s (45.4% of GDP): given that imports comprise, to a large extent, consumer goods of high income elasticity and investment goods, we calculate an income elasticity of imports of 1.4. Hence, a 11.3% reduction of real disposable income calculated above implies a 15.8% real reduction of imports, which is in line with realized trends.

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[3] ECB (WP No 1050, May 2009) estimates that the average wealth effect coefficient is 6-16%. This is compatible with calculations made in this note.

[4] Effects on banks and sectors dependent on them encompass the impact on GDP by the respective increase in unemployment and reduction in profit margins. These are compatible with our projection for a 18% unemployment rate (against 12.1% in 2012), which alone would result in a ca 0.5bn or 3.3ppts reduction of net nominal disposable income. Nominal wages at bes.

2.3. *Baseline Real GDP growth forecast for 2014 (-6.1%)*

Evolution of GDP Components

(b) Private consumption (64.6%of GDP): above mentioned calculations imply that GDP at end 2013 will be ca €16.8bn and net nominal disposable income will be ca €13.5bn.

Strong contractionary impacts on economic activity and incomes will continue to be at play in 2014. With the same logic as for 2013:

1. **Restructuring of the banking sector**: as calculated above, bank assets of Cypriot banks at end 2013 will be €79.6bn and these have to be reduced to €49,9bn by 2017. We assume half of it will be achieved in 2014, i.e. a -18.7% change. This downsizing should further reduce the sector's contribution to GVA by (9.2-0.9)*0.187=1.6ppts of GDP or 2ppts of net nominal disposable income.
2. **Fiscal consolidation measures**. For 2014, fiscal measures of 1.7ppts of GDP are projected. Assuming an equal reduction in net nominal disposable income due to the nature of measures, a reduction of 2.1% in net nominal disposable income will accrue.
3. **Spill-overs** of banks' restructuring on related activities: again we assume elasticity of financial sector activity to those sectors' demand is equal to 0.5. Hence, the reduction in bank assets in 2014 generates half its proportion decline in the contribution of those sectors to GDP, i.e. the impact will be: (0.518-0.025)*0.5*0.187*16.8bn= €0.8bn or 4.6ppts of GDP or 5.7 ppts of net nominal disposable income.

In total, net nominal disposable income is projected to decrease by 9.8%. With a zero GDP deflator for 2014, real disposable incomes should also be reduced by -9.8% in 2014. According to the rationale expressed above, no intertemporal consumption smoothing will be observed in 2014 due to the realization on behalf of households of a lower *permanent* income, i.e. the income elasticity of consumption will revert to unity. Hence, real private consumption will contract in 2012 by -9.8% (against an EC's projection of -5.5%).

(b) Government consumption: (19.4% of GDP): we maintain the MoU projection for a -3.6% contraction.

Final consumption (84% of GDP): -8.9% change.

(c) Gross Fixed Capital Formation: (9.6% of GDP): the development of investment will be contingent on rebalancing happening in 2013 as well as the degree of progress in structural reform. Taking in mind the empirical regularities for investment in crisis countries (threefold decline in relation to GDP) but also mediating for the positive base effect from 2013's steep expected fall and the partial relaxation of capital controls, we project a -13.4% fall (against an MoU projection for a -12% contraction).

Domestic demand (93.6% of GDP): -9.9% change.

(d) Exports of g&s (45.5% of GDP): Ceteris paribus, a downsizing 6.2ppts of GDP or by 9.8% of sectors representing 58.6% of the Cypriot economy's GVA (financial sector and sectors related to it), would result in a reduction of exports by 9.8%. With 3ppts improvement in ULC (rapid wage cuts overshooting reduced productivity due to recession) and 1.2% increase in international demand, we pencil a real reduction of exports by -5.6%.

(e) Imports of g&s (40.6% of GDP): With a favourable base effect from 2013 and a mediation of the decline of GFCF (and hence in the demand for imported investment goods), we use an income elasticity of imports of 1.2. Hence, a 9.8% reduction of real disposable income calculated above implies a 11.8% real reduction of imports.

2.4. Risks to the GDP Projections

A number of downside risks to the main scenaria for 2013 and 2014exist:

Worse domestic credit conditions, causing further deterioration of confidence in the banking system. A credit crunch could magnify the contractionary effect beyond the amount already accounted for by the spill over to sectors related to the financial sector.

Household and corporate defaults propagating through the economy: further banking sector losses, worsening of labour market conditions, stronger than expected fall in house prices and a prolonged loss of business and consumer confidence.

Difficulty in removing temporary capital controls and disruptions due to uncertainty hurting international capital flows; this could further reduce business volumes in both domestic and internationally oriented companies. This is extremely difficult to quantify.

A better-than-the-baseline scenario would involve, according to the MoU, higher investment activity in the energy sector and improvements in the external outlook, should the Euroarea economic activity strengthen beyond expected. However, the former is a longer-term factor and the latter seems unlikely at the current conjecture; the MoU itself admits that the chances of a better scenario materializing are considerably slimmer.

3. Financial sector: stabilization under way after the exit of Bank of Cyprus from resolution status and the gradual relaxation of capital controls

Developments in the financial sector in the post-March era have been driven by the implementation of commitments undertaken as part of the Adjustment Programme. Those aim in the restructuring of the financial sector, the gradual lift of capital controls and structural reforms in the areas of regulation & supervision. Major steps have been undertaken already and progress has been recorded across all areas, albeit with some delay.

3.1 Financial sector restructuring

For the first time since the beginning of the Euroarea sovereign debt crisis, the Programme contained a bail-in scheme, drawing funds from unsecured depositors plus the full contribution of equity shareholders and bondholders. The scheme aimed at funding the resolution of the second largest bank, Cyprus Popular Bank (CPB), and the restructuring and recapitalization of the largest Bank of Cyprus (BoC). The resolution of CPB has minimized the use of public funds with a full bail-in of shareholders and bondholders and a partial bail-in of uninsured depositors (above €100k). CPB was split in two units. The first unit -the legacy- contains all uninsured deposits and non-performing assets. The legacy unit of CPB remains under special administration. The second unit assumed specific CPB assets at fair value, insured CPB deposits and the bank's Emergency Liquidity Assistance (ELA) exposure at nominal value. The second unit will be folded into the recapitalized BoC. In exchange for the positive net asset position transferred, the legacy unit has received 18% of the equity shares into the recapitalized BoC. The uninsured depositors of CPB will be compensated through the proceeds from the asset liquidation of the legacy unit, including this equity stake. Further on, the implementation of the bail-in scheme was completed through the conversion of 47.5% of uninsured deposits (above €100k) in Bank of Cyprus to equity (vs. an initial estimate of 37.5%). The recapitalization process ensures that the core tier I ratio reached 12% now but will also stand at 9% at the end of the Programme.

Bank of Cyprus has exited the resolution status after being successfully recapitalized through the bail-in scheme and regained ECB counter-party status. Upon exit from resolution, another 5% of the uninsured deposits were released. The remaining uninsured deposits (37.5%) were converted into time deposits in three equal tranches of 6-9-12 months with a possibility to roll over once. The General Meeting of the new shareholders took place on September 10 in order to elect a new Board of Directors. The new Board of Directors reflects the ownership shift to the non-resident uninsured depositors. Six out of sixteen members of the new Board are of Russian descent. The next important steps include the appointment of a new CEO and the preparation of a restructuring plan defining the key business objectives by mid October.

The restructuring of the co-operative sector is another milestone event in the financial sector restructuring. It is important to note that the bail-in scheme has not been utilized in the case of the co-operative sector. Instead, Programme funds will be used to recapitalize the sector; €1.5 bn from the second tranche were released on September 27th following the completion of the first review for that purpose. Deliberations on the strategy to restructure cooperative credit institutions have already been completed and the restructuring plan is finalized by the Central Bank. The more than 90 cooperative credit institutions will be merged into 18 entities by March 2014.

Hellenic bank has announced a plan to gather private sector funds. This is based on the plan to convert the Tier 1 and 2 bonds into Cocos. If the plan fails to do so, then the principle of state aid rules will apply. The latter implies that no deposits will be utilized to recapitalize the bank but the bail-in of subordinate bondholders will take place instead.

3.2 Gradual relaxation of capital controls and administrative restrictions

The authorities have agreed with the Troika upon adopting a roadmap for the relaxation of capital controls and administrative restrictions. The roadmap foresees four key phases linking gradual capital liberalization to successful implementation of policy measures. Restrictions on domestic transactions will be abolished first and restrictions on international transactions will follow. The first phase of relaxation has already been implemented.

3.3 Reforms in the areas of supervision and regulation

Major reforms have been initiated and carried out in the areas of supervision and regulation to ensure adequate monitoring and asset quality management.

- The definition of NPLs has changed in order to comply with the international standards. From now on, NPLs will incorporate all loans in arrears for more than 90 days. As a result, the NPLs ratio has profoundly deteriorated. According to the latest IMF report, the NPLs ratio had already reached 30% as of March 2013, with provisioning for loan losses at 30%, well below the average ratio of 50% for European banks.
- The integration of supervision of the co-operative banks under the Central Bank supervision is underway. The data reporting system has already been unified in order to incorporate both commercial and co-operative banks.

- A new regulatory framework to improve lending practices has been agreed. The new regulatory framework requires banks to put emphasis on affordability issues in loan origination vs. over reliance on asset based lending.
- A new framework to monitor private sector indebtness and help troubled borrowers was established.
- An Anti-Money Laundering action plan addressing the remaining legal framework shortcomings is agreed and the Cypriot authorities have committed to ensure its implementation; relevant legislation is prepared.

Overall, the latest financial sector developments were a focal point in our discussions. Our discussants argued that restoring the capital soundness of the banking sector has almost been accomplished. Unless there is a catastrophic scenario materializing in the coming period, the capital needs have been finalized under relatively conservative assumptions, both for the commercial and co-operative sectors. However, restoring confidence in the banking system, a crucial element for economic recovery, has a long way to go. An illustration of that is that deposit outflows have materialized since the first phase of relaxation of capital controls. Net outflows have reached 12.6% of the deposit base as of late August 2013. Of these outflows, 60% corresponded to outflows from non-residents. From that point of view, removing capital controls completely will be the end result of fully restoring public trust to the banking system. The partial relaxation of capital controls has helped entrepreneurs and consumers at this point. Despite the bureaucratic procedures, increased transaction costs involved and the uncertainty surrounding the time frame of full abolition, capital controls are not the main obstacle in the conducting of business. Lack of liquidity to extend new loans and relatively high lending interest rates constrain credit supply and demand respectively. Both are ranked higher in the priority list of concerns for entrepreneurs and consumers. Credit to the economy has started to contract. Corporate credit contracted by 9% yoy in last June while mortgage and consumer lending contracted by 3% and 7% respectively.

4. Hydrocarbons exploration: the confirmation drilling results in Block 12 may have undershoot initial findings, yet showed that gas reserves are substantial

This part attempts to provide an update on the recent developments in the hydrocarbons exploration front. Under the production sharing agreement signed with the Cypriot Government, Noble Energy conducted the confirmatory drilling in Block 12 in June 2013. The new findings from the collected geological data, announced in early October, cleared out most uncertainties regarding the natural gas content of Block 12. The evaluation of those findings has resulted in an updated estimate[5] of gross resources of the field ranging from 3.6-6 trillion cubic feet (Tcf), with a mean of approximately 5 Tcf. Although the updated evaluation is falling short of an initial Noble Energy estimate in Dec2011 of 5-8 Tcf, the field represents the third largest discovered to date within the Deepwater Levant Basin. Noble Energy has also announced that additional appraisal activities are necessary to further refine the ultimate recoverable resources and optimize field development planning. From that point of view, a second confirmatory drilling will most probably be conducted in 2014 in order to reduce the range of resources estimate further, as well as explore additional wells and identify further gas content within Block 12.

The government reaction[6] to the announcement of the results of the confirmatory drilling is that the assessment "confirms there are substantial deposits of recoverable natural gas with significant possibilities of production". To illustrate the size of the reserves, the Minister of Energy explained that every half a Tcf of natural gas represents 25 years of power supply for the Cyprus electricity authority. The lower estimates of the reserves would not fundamentally change the initial government strategy from going ahead with building a (LNG) plant for its offshore gas, as there are other blocks to be exploited; respective reserves would exploit the plant's production capacity and ensure its economic viability. Based on the preliminary assessment, the government expects a profit of $12-18 bn over a 14-year period.

Indeed, 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 (see map at the end of the section). The first geological indications from Block 9 point to a reserve bigger 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 exploration drillings are expected to take place in Q3-2014 and Q1-2015 respectively.

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. With potential gas reserves exceeding 40 Tcf in the six leased blocks and a small domestic gas demand,

[5] http://investors.nobleenergyinc.com/releasedetail.cfm?ReleaseID=794694

[6] http://www.mcit.gov.cy/mcit/mcit.nsf/All/BFC8BD75E932CF23C2257BFA001D2CA2?OpenDocument

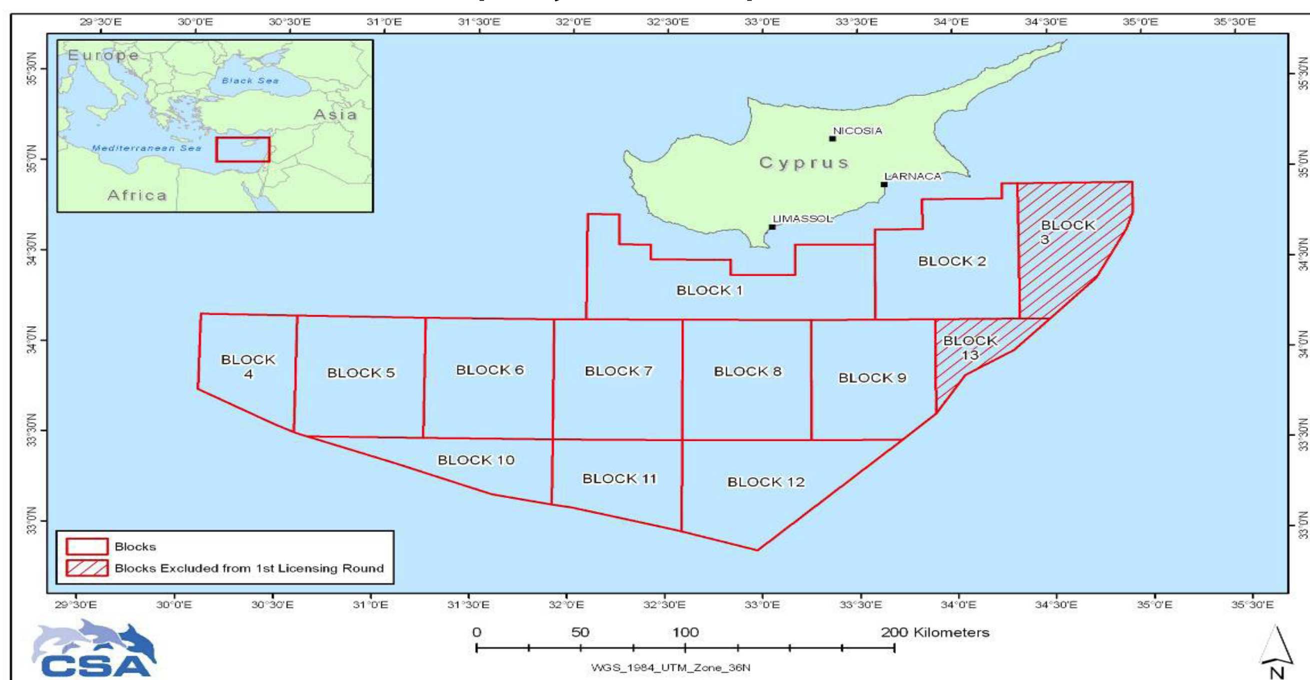
Cyprus is already developing an export strategy. According to the Cyprus National Hydrocarbons Company (KRETYK) chief, Mr. Charles Ellinas[7], the advantageous geographic location of Cyprus-at the crossroads of major international energy routes to Europe and the markets of Far East- makes the island a natural regional hub in the Eastern Mediterranean and the natural location to develop a liquefied natural gas (LNG) plant. Of the possible export options, LNG provides both a practical solution for the quantities of exported gas and the flexibility to serve several markets and customers, an option which pipelines do not offer.

However, the construction of a gas pipeline to the coast and/or an LNG plant plus other gas facilities in the Vasilikos area on the southern coast would require significant capital investments. The land has been initially secured for three trains[8] with 15mtpa of LNG export capacity, possibly expanding up to a total of eight trains in the future. Depending upon the number of trains, the total cost could approximately reach $9-10bn. According to KRETYK, the construction of a liquefaction plant is unlikely to begin before the beginning of 2016, which means that the operation of such a plant can begin no earlier than 2020-2021.

The timely and cost efficient establishment of an LNG plant is of utmost importance because Cyprus will have to compete against exporters from North America and East Africa at that time. As a result, it is important to secure long-term commercial arrangements that underpin the project returns and financing sooner rather than later. The viability and attractiveness of the project could be further strengthened with additional quantities from neighboring countries, Israel and Lebanon.

The energy sector represents a new and lucrative opportunity for the country. It has to be stressed that the bulk of benefits will be realized in a longer-term horizon. However, benefits from gas exploitation are very important, extending beyond licensing fees, direct sales revenue and related investments. They can also span the whole economy due to positive spillover effects. It is estimated that the multiplying effect for the rest of the local economy employment from a direct increase in employment in the hydrocarbons industry is three times higher. The development of the hydrocarbons industry in the medium term will result in the creation of 10,000 jobs and contribute to the reduction of electricity prices by 40%.

Figure 1
Map of hydrocarbon exploration fields



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

[7] The personal views expressed are also contained in this article: http://www.energianews.com/newsletter/files/6db411522b2b87c3cb4c26e960616026.pdf

[8] Infrastructure facilities used to liquefy the incoming gas

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