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FOCUS NOTES: CYPRUS

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Fiscal position to improve this year following recent endorsement of austerity measures

- **Early 2011 economic recovery hindered by lingering euro area debt crisis, munitions accident**
- **Domestic economy expected to broadly stagnate this year, with return to more sustained growth seen likely in 2013**
- **Public finances deteriorated in the past three years due to structural and cyclical factors**
- **Fiscal position to improve in 2012 on recently-adopted austerity measures**
- **Cyprus in a better position than other euro area economies to weather the sovereign debt crisis**

Early 2011 economic recovery hindered by euro area debt crisis, munitions accident

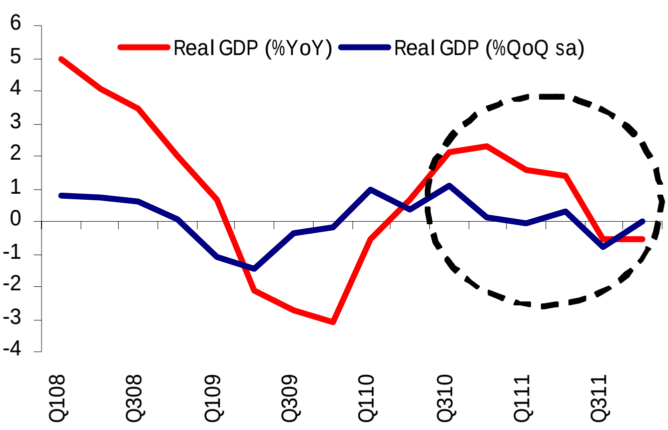
Cyprus's economy staged a tentative recovery in the first half of 2011, mainly on the back of stronger private consumption (+1.3% yoy) and exports (+5.7%yoy). Services exports were particularly buoyed by an exceptionally good tourism season; foreign arrivals rose by 10.9%yoy and tourism revenues soared by 17.1%yoy in H1-2011. These positive trends more than outweighed a further significant contraction in domestic investment activity (gross fixed capital formation and construction output fell by 8.8%yoy and 7.2%yoy, respectively in the first half of 2011).

Yet, the deepening euro area debt crisis and a munitions accident last summer weighed on domestic economic activity in H2-2011. Business and consumer confidence waned and real GDP contracted by 0.5%yoy after recording positive growth of 1.4%yoy in the first half of the year. As a reminder, a massive blast in a munitions depot at a naval base occurred in July 2011, where containers of explosives confiscated from an Iranian ship were stored. The fire spread to the nearby Vasilikos power plant, the island's largest power facility estimated to generate around half of Cyprus's electricity. The plant was severely damaged, resulting to widespread power cuts, which disrupted businesses and households alike.

In another blow to the nascent output recovery in early 2011, the euro area debt crisis has affected the domestic economy through three main channels; namely, trade, foreign investment and the financial channel. Tightened domestic lending conditions (Figure 2) took a toll on private consumption and investments. Meanwhile, weakening demand from abroad as a result of worsening conditions in main trade-partner economies weighed on exports growth. Note that the euro area absorbs around 40% of Cypriot goods exports and generates 25-30% of tourist inflows. Moreover, a significant deterioration in the country's fiscal outlook over the past three years necessitated the implementation of additional fiscal measures, with four successive austerity packages having been voted in the Cypriot Parliament since last August.

Against this background, the domestic economy contracted marginally in H2:2011, with full-year GDP growth coming in at 0.5%yoy (Table 1). The breakdown of the data showed that domestic demand shrunk by 3.4%yoy in FY2011, driven primarily by a 13.8%yoy contraction in gross fixed capital formation (-1.7%yoy in 2010). A 4.7ppts decline in government expenditure after a slight expansion of 0.8%yoy in the prior year also weighed, while private consumption growth slowed to 0.2%yoy from 1.3%yoy in 2010. On the other hand, weakening domestic demand dynamics resulted to a notable decline in imports, which contracted by 5.0%yoy in 2011 after growing by 4.9%yoy a year earlier. On a more positive note, exports of goods and services continued to expand (+3.6%yoy in 2011), primarily thanks to exceptionally strong tourism revenue in the first nine months of the year.

Figure 1: Domestic economy weakened in H2:2011



Source: Statistical Service

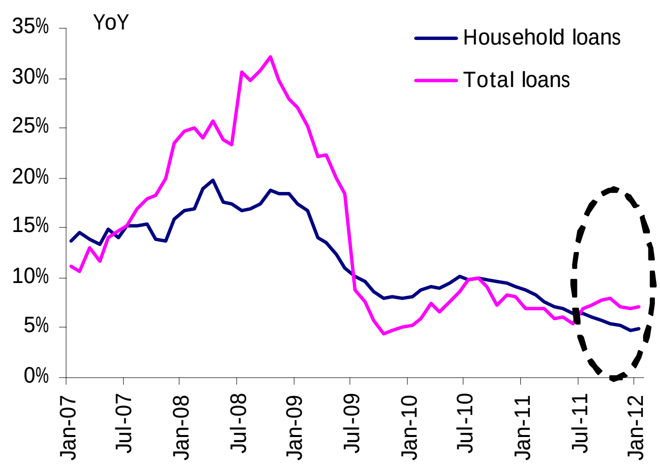
Signs of a lingering slowdown in the domestic economy have also been evident in the most recent readings of a range of higher-frequency real activity and sentiment indicators. Among others, industrial output contracted by 10.4%yoy in Q4-2011, after retreating by 6.5%yoy in the first nine months of the year. Building permits, which constitute a leading indicator of future construction activity, declined by 13.3%yoy in the first nine months of 2011, with the corresponding rate of contraction deepening to 18.1%yoy in Q4 -2011. In total value terms, permits plunged by 21.4%yoy in the 12-months to December 2011.

Elsewhere, retail sales fell by 3.6%yoy in Q4-2011, after registering broadly stagnant growth in the January-September period. Also reflecting weakening domestic demand dynamics, motor vehicles' registrations plunged by 23%yoy in January 2012 after declining by 18%yoy in FY2011. In an indication of worsening labor market conditions, the number of registered unemployed in February 2012 was around 27.1%yoy higher from the same month a year earlier. This compares with corresponding readings of 28.4%yoy in December 2011 and 21.2%yoy in December 2010.

Regarding credit dynamics, annual credit growth to the domestic economy averaged 6.9%yoy in 2011 (January 2012: +7.0% yoy), comparing to 7.9% in 2010 and double-digit rates witnessed before the 2009 recession. Furthermore, annual credit growth to domestic households stood in January 2012 just 2bps above a multi-year low rate of 4.7% yoy recorded in December 2011.

Finally, revenues from the tourism sector rose by 5.9%yoy in the fourth quarter of last year, following a 14.4%yoy expansion in 9M-2011, with growth slowing down further, to 0.7%yoy in January 2012.

Figure 2: Bank loans growth slowed down in last couple of years



Source: CBC, Eurobank EFG Research

Domestic economy expected to broadly stagnate this year; return to more sustained growth likely in 2013

We expect the mild output contraction evidenced in the second half of last year to broadly continue in H1-2012, mainly reflecting the ongoing domestic fiscal consolidation and weakened demand conditions in the economies of main trade-partners.

(Eurobank EFG Research expects the euro area economy to contract by 0.8% in H1-2012 and to register broadly flat growth for the full year).

Domestic manufacturing and construction are unlikely to stage a meaningful recovery any time soon, while scarcer domestic credit and worsened labour market conditions will continue to weigh on domestic demand dynamics. The sectors of tourism and services will likely continue to support domestic economic activity for the greatest part of 2012, with net exports remaining a positive contributor to overall GDP growth, mainly as a result of negative growth in imports.

Conditional on a more powerful policy response to the euro area debt crisis, a mild recovery in the domestic economy may be witnessed in the second half of the year as demand from abroad strengthens and confidence towards the region improves. Looking further ahead, a further tentative recovery is likely in 2013 as domestic and external demand gradually recover. Importantly, success over the recent offshore gas exploration operations may provide a significant boost to Cyprus's energy-dependent economy over the coming years.

Table 1: Key macroeconomic indicators

	2010	2011E	2012F
Real GDP (yoy%)	1.1	0.5	0.0
Domestic Demand	1.9	-3.4	-2.5
Final Consumption	1.2	-0.9	-1.6
Private Consumption	1.3	0.2	-0.5
Government Consumption	0.8	-4.7	-5.5
Gross Fixed Capital formation	-1.7	-13.8	-5.0
Exports	3.7	3.6	2.0
Imports	4.9	-5.0	-3.5
Inflation (yoy%)			
HICP (annual average)	2.6	3.5	2.7
HICP (end of period)	1.9	4.1	2.3
Fiscal accounts (GDP%)			
General Government Balance	-5.3	-6.5	-2.8
Gross Public Debt	61.0	66.0	67.0
External accounts (GDP%)			
Current Account	-9.9	-11.0	-8.5

Source: National Sources, Eurostat, European Commission, IMF, Eurobank EFG Research

Domestic inflation on the rise on tax hikes, higher energy costs

Cyprus's harmonized consumer inflation stood at 4.1%yoy in December 2011 from 1.9%yoy in the same month a year earlier, bringing last year's average rate of increase to 3.5%yoy. (The latter compares with average annual inflation of 2.6% in 2010). The acceleration primarily reflected a 5ppts VAT hike to 5% on foodstuff and pharmaceuticals introduced in January 2011 as well as increased excise duties on petroleum products and tobacco that came into effect in mid and late 2010. Rising oil prices and higher electricity costs in the wake of the munitions accident also added to price pressures in recent months.

For 2012, we anticipate a deceleration in domestic inflation primarily due to weaker domestic demand and favorable base affects as the impact of tax hikes fades. A slowdown is already evident in the first couple months of the year, with HICP easing to 3.1%yoy in February 2012. However, the disinflation process will likely be partially obstructed by the increase in the main VAT rate that came into effect on March 1, 2012.

Pace of improvement in the current account balance wanes

Cyprus's current account deficit (CAD) narrowed to 9.9%-of-GDP in 2010, from 10.7%-of-GDP in the prior year and a record-high shortfall of 15.6%-of-GDP registered in 2008. However, the most recent data points to a new deterioration in recent quarters.

In detail, the CAD widened by 30%yoy in the first nine months of last year, reaching 1,426.8mn,or 7.9% of (full-year) GDP. The latter compares with a deficit of 6.3%-of-GDP registered in the same period a year earlier. The deterioration appears to have been primarily driven by a wider deficit in the incomes account, to ca 3.4%-of-full year GDP in 9M-2011, from a shortfall of 0.9%-of-GDP recorded in the same period a year earlier. This, in turn, mainly reflects lower direct investment income from abroad, which swung into a deficit of €378mn over the aforementioned period from a surplus of €158.6mn in January-September 2010.

Somewhat mitigating these negative developments, the overall deficit of the merchandise trade and services balance narrowed by 19.5%yoy in the nine months to September 2011, as growth of 6.9%yoy in goods and services exports (€5,549mn) outpaced a 3.2%yoy increase in corresponding imports (€6,232mn).

On the financing side, portfolio and foreign direct investments fully financed the current account deficit, amounting to €2,837mn and €1,315mn, respectively. In all, we pencil in a small deterioration in the current account deficit to 11%-of-GDP last year, but anticipate a resumption of the earlier improvement trend and a deficit of 8.5 %-of-GDP in 2012 as weak domestic demand dynamics weigh on imports' growth.

Public finances deteriorated in the past three years due to structural and cyclical factors

Cyprus's fiscal position underwent a considerable deterioration in the past three years, with the general government balance swinging from surpluses of 3.5%-of-GDP in 2007 and 0.9%-of-GDP in 2008 into respective deficits of 6.1%-of-GDP and 5.3%-of-GDP in 2009 and 2010. The general government deficit is estimated to have reached 6.5%-of-GDP last year (full-year data in ESA-95 terms not out yet).

Among the main culprits behind the worsening in government finances were increases in social transfers due to the economic recession, higher debt servicing costs and discretionary fiscal stimulus measures aiming to shield the domestic economy against the global financial crisis. From the receiving side, weakened domestic demand resulted into weaker VAT receipts and lower tax payments, mainly from the construction and real estate sectors. Notably, the Finance Ministry estimated the amount of lost revenues as a result of the downturn in the real estate sector at about 2½-of-GDP in 2009 and 2% in 2008.

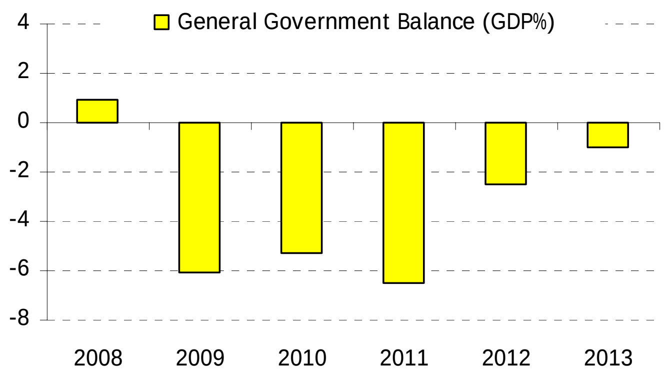
The munitions accident last summer aggravated fiscal worries further due to its potential impact on output and revenues. Yet, somewhat comforting is the fact that most of the power facility's reconstruction costs will likely be covered by insurance companies. For FY-2011, the government's latest forecast (presented in the 2012 Budget Law) is for a shortfall of 6.5%-of-GDP, which compares with an initial budget deficit target of 4.5%-of-GDP.

According to monthly budget execution data (cash basis), the consolidated deficit of the central government budget and administered funds amounted to around 6%-of-GDP in the 12 months-to-December 2011. These figures do not incorporate local government accounts, but given that local authorities constitute only a small share (ca 0.1%-of-GDP) of the general government budget, we surmise that the revised full-year deficit target of 6.5%-of-GDP has likely been reached.

Four consecutive austerity packages adopted since last August

Prior to last summer's munitions accident, the government had introduced a number of fiscal consolidation measures in a move to facilitate attainability of the 4.0%-of-GDP budget deficit target set out in the Stability Programme for the period 2010-2014. (*For more analysis on the latter issue please see Cyprus Trip Notes May 25, 2011* *http://www.eurobank.gr/Uploads/Reports/Country%20Focus%20%20Cyprus%20May%202011.pdf*).

Figure 3: Fiscal outlook improves on recently adopted austerity measures



Source: European Commission January 2012, national authorities

However, it eventually became clear that the aforementioned target was likely to be missed, necessitating the adoption of additional austerity measures. Acknowledging the urgent need for a strengthening of its fiscal consolidation effort, the government introduced a number of new adjustment measures, laid out in four separate packages that were endorsed in parliament in August and December 2011.

According to official estimates (see http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2012:0049:FIN:EN:PDF) the fiscal consolidation impact of the first package will be around ½%-of GDP-per annum in 2011-2012. Furthermore, the fiscal consolidation impact of the other three packages is estimated to be: 3%-of-GDP in 2012 from the second package; ca ¼%-of-GDP in 2012 and ¾%-of-GDP in 2013 from the third one; and ½%-of-GDP in 2012 from the fourth package. Among the measures endorsed were:

from the expenditure side,

- A ca 8% reduction in selected government expenditure items, including ministerial cars, suspension of leasing of the presidential jet, abolition of interest-free loans to civil servants for car purchases and a blanket ban on new hires in the civil service

- a permanent increase in public-sector employees' social security contributions to 3.0% of gross earnings from 2.5% earlier
- an increase in public employee contributions to the Widows and Orphans Fund, from 0.75% to 2% of gross earnings
- introduction of a temporary contribution on gross earnings of broader public sector employees and pensioners to 3.5% from 0% for a 2-year period
- reductions in the number of public-sector employees by 5k over the next five years
- a better targeting of all social schemes based mainly on income and economic criteria
- a 2-year freeze in public sector salaries
- reductions in the overtime pay by an additional 20% in 2012

from the revenues side

- higher taxation on property and changes in the method of calculation
- a 5ppts increase to 35% of the income tax rate for high earners (above 60k annual income)
- a €350 annual fee on registered companies
- increase of the tax rate on deemed dividend distribution by 5ppts to 20%
- a 5ppts increase to 15% of the withholding tax on interest accrued on domestic bank deposits
- a 2ppts hike in the main VAT rate to 17% as of March 1, 2012 (estimated to generate around €160mn of additional government revenue per annum)
- a proportional levy on private-sector salaries above €2,500

The 2012 budget, which passed in parliament in mid-December, takes into account the aforementioned measures and targets a general government shortfall of 2.5%-of-GDP, down from an estimated deficit of 6.5%-of-GDP last year. In a vindication of the government's and other political parties' fiscal consolidation efforts, the European Commission deemed in early January that the action taken was effective and noted that it would no longer consider any further steps under its excessive deficit procedure against Cyprus. Note that the government does not enjoy parliamentary majority and relied on opposition parties to pass the latest four fiscal consolidation packages.

A series of downgrades of Cyprus's sovereign credit ratings in recent months

Worries over the deepening debt crisis in the euro area, the country's deteriorating fiscal position and the large exposure of the Cypriot banking sector to Greece have been on the rise in recent months. The munitions accident aggravated such concerns further, negatively weighing on domestic consumer and business confidence. As a result of these developments, the government has lost access to international debt markets.

Cyprus had in the past been meeting its public borrowing needs primary through the domestic market, but the hefty increase in government bond yield spreads since early 2011 deemed new borrowing increasingly expensive, fanning worries over the Republic's ability to continue servicing its debts. Note that the mid-yield of the 4.625% Feb. 2020 benchmark bond hit a record high just below 14% (Figures 4 & 5) early last month. This was well above the levels where other euro area member states requested official bailout support.

In response of the aforementioned, Cyprus's sovereign credit ratings came under increased pressure since the beginning of 2011. The latest move in a series of recent rating downgrades (Table 2), came earlier this month, when Moody's lowered its foreign and local currency long-term credit ratings on Cyprus by one notch to "Ba1". The short-term ratings were also downgraded, to "NP" from "P3". The outlook assigned was negative.

Of all three major agencies, S&P and Moody's currently rate Cyprus's sovereign debt in the non-investment area. As outlined by Moody's in early March, the main reasons behind the latest bout of rating downgrades included, among others **i)** increased risks to the domestic banking system due to its high exposure to Greece and the potential need for state support to the sector, which would, in turn, weigh further on public debt dynamics and the government's fiscal accounts; **ii)** deteriorated market sentiment towards the country, as a result of the aforementioned risks and uncertainties surrounding, among other, Europe's macroeconomic prospects.

On a more positive note, Moody's acknowledged that the adoption of a series of fiscal consolidation measures will likely assist to push the budget deficit below 3%-of-GDP this year. Moreover, the ECB's liquidity injections through its 3-year Long-Term Refinancing Operations (LTROs) in December 2011 and late February this year provided support to the Eurozone's financial system and had a positive impact on investor sentiment towards periphery markets.

Table 2

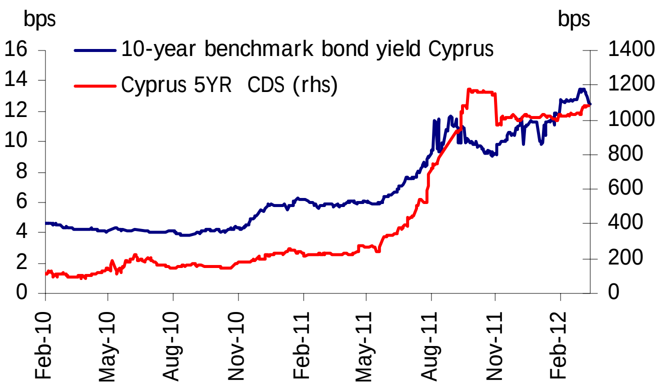
	Current Rating	Date of last rating action	Action	Outlook
Fitch	BBB-	27/1/2012	1-notch down	Negative
S&P	BB+	13/1/2012	2-notches down	Negative
Moody's	Ba1	13/3/2012	1-notch down	Negative

L-T Foreign Currency Ratings

Source: Ratings agencies, Reuters, Bloomberg

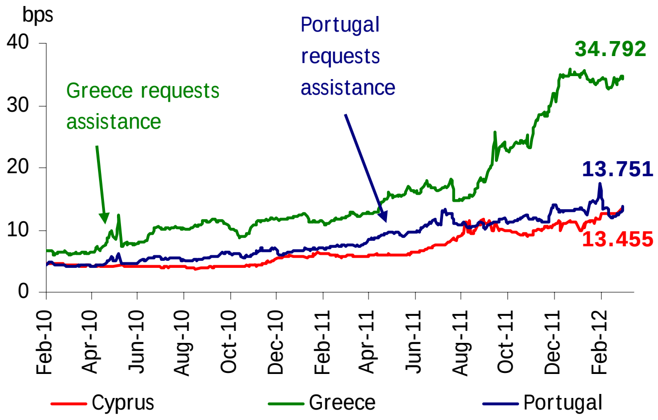
In response, Cyprus's five-year credit default swap spreads marked a more than 120bps narrowing in mid-March compared to their peak levels above 1,200bps hit last September. A marginal improvement was also evident in government bond yields with the mid-yield of the 4.625% February, 2020 paper standing nearly 100bps lower on March 12 from a lifetime high of 13.93% (Figures 4 & 5) temporarily touched in early February.

Figure 4: 5YR CDS spreads and benchmark bond yields



Source: Bloomberg, Eurobank EFG Research

Figure 5: Comparison of 10-year government bond yields



Source: Bloomberg, Eurobank EFG Research

Cyprus features sounder fiscal fundamentals than other economies in the euro area periphery

In spite of the aforementioned concerns, Cyprus is fundamentally in a much better position than other euro area periphery economies to weather the lingering sovereign debt crisis. Firstly, with a general government deficit of ca 6.5%-of-GDP as of the end of 2011 (and expectations for a substantial improvement this year due to fiscal austerity measures) and a gross public debt ratio well below the euro area average (66%-of-GDP vs. 88%-of-GDP in 2011), Cyprus features much sounder fiscal metrics relative to other crisis-hit economies, including Greece, Portugal, Ireland and Spain.

Secondly, with total bond redemptions for this year and the next amounting to around €5bn, which makes up for more than half of the total amount of government paper maturing through to 2021, Cyprus faces a more manageable debt-servicing situation relative to other economies in the euro area periphery.

Moreover, the endorsement of substantial fiscal austerity measures and the implementation of the loan from Russia will assist the government to cover its financing needs for this year. In detail, Cyprus agreed last October on a €2.5bn loan with Russia. It encompasses a favorable interest rate of 4.5%, well below the current market rates, and does not incorporate a penalty in case of early repayment. It is the first country in the region to resort to bi-lateral borrowing rather than opt for an official rescue package from international (EFSF/IMF) lenders. The deal came into effect in January 2012 and has a repayment period of 4.5 years. The money will be utilized for short-to-medium term budgetary financing, including upcoming bond redemptions. Thanks to this loan, Cyprus's financing requirements for 2012 have been covered, according to the government. The first two tranches

(€590mn and €1.32bn) have already been released and the last (€590mn) is scheduled for disbursement by the end of March.

Gas drilling operations expected to have a long-lasting positive impact on the domestic economy

Another area that could provide significant benefits to the domestic economy, albeit from a more medium-term perspective, is the recently-began offshore gas exploration operations. Currently, the government has offered a permit to US drilling company Noble and the area under exploration is termed as "Block 12".

Initial estimates have shown that "Block 12" may contain around 5-8 trillion of cubic feet of natural gas, which could be reportedly worth tens of billions of dollars. Although it is too soon to quantify these preliminary findings, they indicate potential for a long-lasting support to the domestic economy, by significantly alleviating the country's dependency on energy imports, increasing gas exports to the EU and other regions, supporting investments and boosting the government's coffers revenues via, among others, licensing operations.

There are twelve more blocks that the government plans to offer exploration licenses for. For those, it launched a second hydrocarbons licensing round for oil and gas explorations in mid-February. Reportedly, more than 50 companies have shown preliminary interest. However, the completion of the undergoing process is anticipated to last a few months and possibly be finalized next year under the tenure of a new government.

Domestic banking system remains well equipped to cushion external shocks

According to CBC estimates, as of end-June 2011 (latest available data), the ratio of total consolidated assets of Cyprus's entire banking sector stood at 764%-of-GDP. Out of the total of 41 banks located in Cyprus, only 6 are domestic, with the remaining 35 being foreign subsidiaries or branches. Nevertheless, domestic banks account for a share of 70% of total consolidated banking sector assets which corresponds to 542%-of-GDP (end-June 2011). As a result of its sheer size, developments in the banking sector are of particular significance for the domestic economy as well as for preserving financial stability.

The debt crisis in the euro area and the sector's high exposure to Greece have fanned concerns about the sector's deteriorating balance sheet and ensuing financial stability risks. According to CBC estimates, the three largest Cypriot banks held €5.3bn of Greek government paper and had a €23.5bn (around 34% of total lending) exposure in direct loans to Greek customers as of end-September 2011.

In spite of its large size, the Cypriot banking system appears well equipped to cushion potential spillover risks from the euro area sovereign debt crisis. Despite of the recent downgrades, ratings agencies acknowledged that in the short-term the sector should remain well capitalized and that "capital and liquidity buffers have been strengthened over the past year, thereby improving their shock absorption capacity".

However, at the statement issued upon the latest downgrade in March, Moody's estimates that the amount of capital support which may be required to be extended from the government to domestic banks is in the area of 5-10%-of-GDP. Under its base case scenario, the ratings agency also expects that in view of losses incurred by Cypriot banks due to their participation in Greece's private sector involvement (PSI) and the asset quality deterioration in both Cyprus and abroad, a 20%-of-GDP capital increase will be required in order for them to revisit their current Tier-1 capital levels.

In view of the debt crisis in the euro area, the Central Bank of Cyprus has already taken a number of steps to support the domestic banking sector. Among others, these include: a) measures for the improvement of the overall prudential liquidity framework for banks; b) enhanced supervision of domestic financial institutions; c) a required strengthening of banks' capital positions; and d) the establishment of an independent Financial Stability Fund, aiming to improve financial operations, ensure financial stability and provide financial aid, if required.

The country's largest banks have already intensified their efforts to strengthen their capital positions in order to meet the 9% core Tier 1 threshold by June 2012, as required by regulators. In order to achieve the new threshold and enhance their capital liquidity levels, banks have resorted to rights as well as convertible and covered bonds issues in recent months and announced capital strengthening plans in early January (prior to the finalization of the terms of Greece's PSI) so as to achieve the necessary 9% Core Tier 1 ratio by end-June.

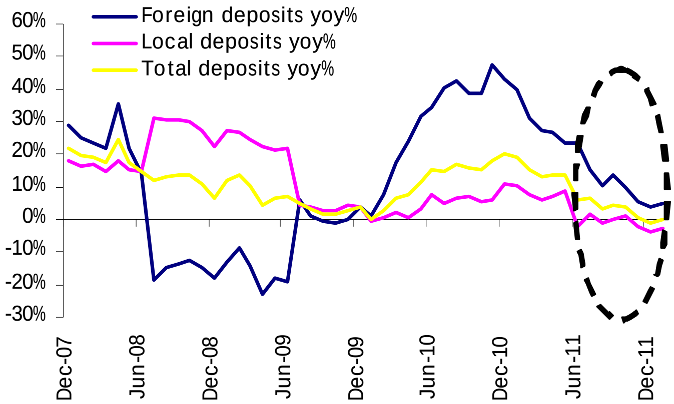
Under its January capital enhancement plan, Marfin Popular bank plans to raise up to €1.8bn of additional capital through exchanging part of its current securities into core Tier 1 capital instruments as well as through internal profit generation and deleveraging. According to reports, it is also currently holding discussions with new investors (the second largest Russian bank, VTB, has been recently cited as a potential investor by the local media). Separately, Bank of Cyprus announced a €1.0bn loss on a 60% writedown on its Greek debt holdings for FY2011 and plans to raise €400mn through a rights issue and €600mn via the voluntary exchange of Convertible Enhanced Capital Securities

(CECS). The bank also plans deleveraging measures, such as the sale of its Australian subsidiary, which is already underway.

With regards to other financial stability metrics, the Core Tier 1 capital of the entire banking system increased to 9.4% last June from 8.7% in December 2010, remaining comfortably above the 8% minimum requirement set in July 2011. Separately, in spite of its more recent increase, the loans-to-deposits ratio stood below parity in January 2012 (98.2%), indicating adequate liquidity conditions in the domestic financial system.

A slowdown in the annual growth of domestic bank deposits is being observed since last May, primarily as a result of deposit withdrawals by domestic households and businesses. Even so, the annual growth of foreign resident deposits in the Cypriot banking system remains positive, signaling continuing confidence in the stability of the domestic economy (Figure 6). The latter also somewhat mitigates concerns about a high private sector lending-to-GDP ratio, which stood at 260% in January 2012. NPLs as a percentage of total loans increased to 8.13% in June 2011 from 7.32% in December 2010, reflecting a modest deterioration in the banking system's balance sheets.

Figure 6: In spite of a slowdown, the growth of foreign resident deposits in the Cypriot banking system remains positive, reflecting continuing confidence towards the domestic economy



Source: CBC, Eurobank EFG Research

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