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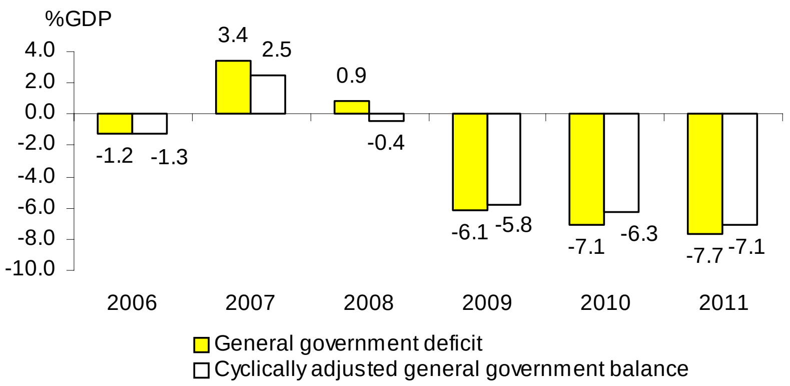
Focus notes: **Cyprus**

Country focus: Cyprus[1]

Key points:

- **Domestic economy in recession since the first quarter of 2009**
- **High-frequency indicators signal worst of economic recession is probably behind; recovery likely to prove slow and gradual**
- **Broadly flat GDP growth expected in 2010**
- **EU launches disciplinary action against Cyprus**
- **The government plans a number of measures to correct its excessive deficit by 2013**
- **Current account deficit improves due to domestic economic recession**
- **Inflation picks up in recent months but a further spike from current levels likely to be caped by weak domestic demand**
- **High household indebtedness remains a concern, but sound domestic banking sector likely to cushion potential shocks**
- **Worries over a slowdown in reunification talks after nationalist Dervis Eroglu wins Presidential election**
- **Reunification is expected to boost medium-term growth**

A trend deterioration in Cyprus' fiscal position



Source: EU 2010 Spring forecasts

[1] *Our analysis incorporates views shared and discussions held during our trip to Cyprus in late 2009, when we met with officials from the Cypriot Central Bank, the Finance Ministry as well as market participants to discuss recent economic developments and prospects going forward.*

Cyprus: Realisation and Eurobank EFG Forecasts				
	2008	**2009E**	**2010F**	**2011F**
Real GDP (yoy%)	3.6	-1.7	0.0	1.5
CPI (annual average)	4.7	0.3	2.6	2.8
CPI (end of period)	2.1	2.1	3.0	3.3
General Government Balance (% GDP)	0.9	-6.1	-6.5	-7.3
Gross Public Debt (% GDP)	48.4	56.2	61.5	66.0
Current Account (% GDP)	-17.7	-8.5	-7.5	-8.0

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

Domestic economy in recession since the first quarter of 2009

The Cypriot economy has been in recession since the first quarter of 2009. Annual GDP growth contacted by 1.7% last year after recording positive growth of 3.6% and 5.1% in 2008 and 2007, respectively. This was the first negative (annual) GDP reading in more than three decades. Private consumption fell by 3%yoy, hit hard by tightened domestic credit, deteriorating labor market conditions and worsening consumer morale. Gross fixed capital formation declined by 12%yoy, bearing the brunt of declining foreign demand for real estate and narrowing corporate profit margins. With respect to external-sector developments, the recession in main trading-partner economies dealt a severe blow to the domestic export sector, with exports of goods and services registering an 11.8%yoy plunge. A stronger euro against both the sterling and the US dollar also weighed on tourist arrivals last year, with receipts plunging by 16.7%yoy[2]. Construction and real estate were particularly hit by the global economic crisis. Construction output contracted by 6.8%yoy in 2009, registering the first annual decline since 2000. The fourth quarter of 2009 saw the pace of domestic recession deepening, with real GDP growth contracting by 3.1%yoy, following respective declines of 2.7%yoy and 1.6%yoy in the two prior quarters.

GDP contracted further in Q1 2010

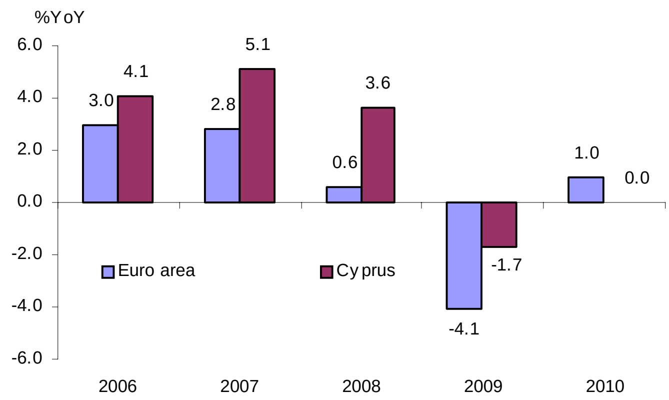
The domestic economy remained in recession in Q1 2010, registering GDP growth of -2.4%yoy (and -0.2%qoq). This contrasts with positive economic growth recorded in most of EU-27 economies over the same period. Construction, trade and manufacturing all recorded negative growth readings in the first quarter of 2010. On a more positive note, some preliminary signs of recovery started to emerge in the services sector. Furthermore, the pace of GDP contraction eased somewhat in Q1 2010, suggesting that the trough of the recession was probably reached in Q4 2009.

High-frequency indicators signal worst of economic recession is probably behind; recovery likely to prove slow and gradual

Recent economic-activity and survey data have been rather mixed, signaling that an economic rebound is likely to prove slow and gradual. In detail, tourism revenues grew 3.5%yoy in Q1, recording a 14.3%yoy jump in March alone. The spike was primarily due the Easter holiday, which took place quite early this year. However, even though tourist arrivals jumped strongly in March, the April data showed a sharp reversal (-23%yoy). The latter brought the total number of foreign visitors in the first four months of the year down 8.2% from a year earlier. On a more positive note, recent readings in a number domestic activity indicators raise optimism that the economy will probably fare better in the months and quarters ahead. Among others, the annual rate of growth of loans to non-financial corporations and households jumped to 7.3% yoy in March, having reached a multi-year trough of 4.4%yoy two months earlier. Furthermore, Cyprus's economic sentiment indicator touched a multi-month peak of 85.6 in April, while a similar survey conducted by the University of Cyprus also revealed a sharp rise that month. Meanwhile, credit-card transactions grew by 5%yoy in Q1 2010, signaling a potential stabilization in domestic consumption dynamics. Credit card transactions grew by 1%yoy in 2009. Nevertheless, the ongoing increase in the rate of unemployment in recent months suggests that a *sustainable* economic rebound may still be some way off.

Figure 1

Domestic economy growth likely to remain stagnant in 2010



Sources: National statistics, EU 2010 Spring forecasts, Eurobank EFG Research forecasts

Broadly flat GDP growth expected in 2010

Looking ahead, the economy is broadly expected to stagnate this year (Eurobank EFG Research forecasts 0.0% GDP growth in 2010). Private consumption and investment activity are likely to remain subdued, while government spending and net exports are expected to exert a positive contribution to GDP growth this year. Cyprus's Central Bank forecasts GDP growth of 0.3%yoy in 2010. Yet, Governor Orphanides warned in early April that a negative GDP reading this year can not be ruled out, urging the government to pursue reforms to restore public finances and support long-term growth. The country's new Stability Programme pencils in growth of 0.5%yoy in 2010, envisaging a pickup towards levels of 3%yoy by 2013. Longer-term, a successful reunification deal could provide a powerful growth driver in the years to come. At its spring 2010 forecasts the European Commission envisaged a contraction of 0.4%yoy in 2010 with a rebound to a positive reading of 1.3%yoy in 2011.

EU launches disciplinary action against Cyprus

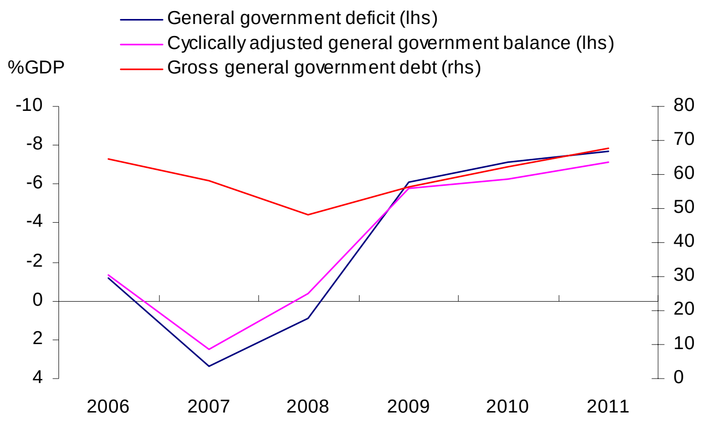
The global crisis has taken a heavy toll on domestic public finances. In 2009 the general government balance deteriorated sharply, reaching a deficit of 6.1%-of-GDP[3]. The sharp

[2] Tourism is estimated to account for ca 11% of gross domestic product.

[3] Fiscal surpluses of 3.4%-of-GDP and 0.9%-of-GDP were recorded in 2007 and 2008, respectively.

worsening was due to both cyclical and structural factors, which included, among others, hefty social transfers, expenditure overruns as a result of a range of emergency support measures introduced in late 2008 and lower tax revenues due to the economic slowdown. Meanwhile, the European Union initiated in mid-May an excessive deficit procedure (EDP) against Cyprus as the country breached in 2009 the Treaty's 3%-of-GDP deficit threshold.

Figure 2
Cyprus's fiscal position expected to deteriorate further unless necessary measures are employed



Sources: EU 2010 spring forecasts

Fiscal position risks a further deterioration this year on persisting structural weaknesses

In its 2010 Spring Forecasts, the European Commission estimated Cyprus´cyclically-adjusted budget balance to have switched from a surplus of 2.5%-of-GDP in 2007 to respective deficits of 0.4% and 5.8%-of-GDP in 2008 and 2009. Even worse, a further deterioration in the cyclically-adjusted balance is expected both this year and the next, with the corresponding deficit reaching 7.1%-of-GDP in 2011. This is despite an expected return to positive GDP growth next year and reveals a multitude of structural problems that need to be addressed in the years to come. Particularly, over the last couple of years, largely untargeted increases in social transfers and civil servant benefits have contributed to a trend-deterioration in the fiscal balance, which is now exacerbated by lower revenues due to the economic downturn.

The government plans a number of measures to correct its excessive deficit by 2013

The 2010 Budget Law that was passed in parliament in December envisaged a fiscal deficit target of 4.5%-of-GDP. However, this figure was based on a 2.9%-of-GDP deficit projection for 2009, which was more than twice exceeded. Accordingly, the government revised earlier this year its 2010 fiscal deficit forecast to around 7%-of-GDP. The Stability Programme (SP) released in April included macroeconomic assumptions that were similar to those envisioned in the 2010 Budget Law. Namely, it forecasts GDP growth of 0.5%yoy and inflation of 2.75%yoy this year. A further acceleration of GDP growth towards 3%yoy is expected by 2013.

Furthermore, the government outlined a set of measures, aiming to contain the fiscal deficit to levels around 6%-of-GDP this year, and reduce it gradually to sub-3%-of-GDP levels by 2013. These measures included among others:

I. A freeze in public sector employment in 2010-2013

II. Containment of the rate of growth of the total wage bill in the public and broader public sectors in 2010-2013

III. A 10% reduction in the benefits of senior state officials including the President of the Republic, Ministers and Members of Parliament; This measure will be adopted in 2011

IV. Introduction of a mechanism for better targeting of a wide range of social transfers

V. Termination of the policy of lowering the excise duty on heating oil during the winter season

VI. Reductions in operational and other expenditures starting in 2010

VII. Prioritization of infrastructural projects in 2010-2012

VIII. Introduction of new legislation to enable the Inland Revenue Department to better enforce tax legislation and improve tax compliance. The relevant legislation is expected to be adopted in 2010

IX. Other measures including the application of the minimum excise duties prescribed by the acquis on petroleum products in 2010, reduced VAT rate on food products and pharmaceuticals as prescribed by the acquis in 2011, reform of the pricing policy of water usage as prescribed by the acquis in 2011 and dividend income from various semi-governmental organizations in 2010

These measures are expected to reduce the general government budget deficit by 1.5ppts of GDP in 2010, by 2.5ppts of GDP in 2011 and by 1.5ppts of GDP in each of the years 2012 and 2013.

Note also that the government enacted in April 2009 a range of pension reforms, which are expected to contain until 2050 the reserve balance of the Social Security Fund at today's level of 40%-of-GDP. This compares with a 90%-of-GDP shortfall forecasted in the absence of such reforms. The reforms include increases in social insurance contributions that will be endorsed gradually through to 2035 as well as a tightening of eligibility criteria for social insurance pensions.

The government also plans to implement a range of structural reforms, including in the area of the healthcare system. These reforms include policies to: a) facilitate infrastructural improvement b) enhance labour market flexibility *via e.g., measures to narrow the high gender wage gap* c) increase competition and improve the business climate d) cut red tape in the economy and boost R&D and e) reorganize public hospitals and introduce gradually the National Health Insurance Plan.

In terms of additional corrective fiscal measures, our contacts argued in favor of i. measures to downsize an already saturated public sector and ii. a slowdown or postponement in investment projects which could also assist alleviate some of the pressure from the government's finances. On the flipside, powerful unions seeking additional civil servant benefits pose a significant risk to fiscal consolidation in the period ahead.

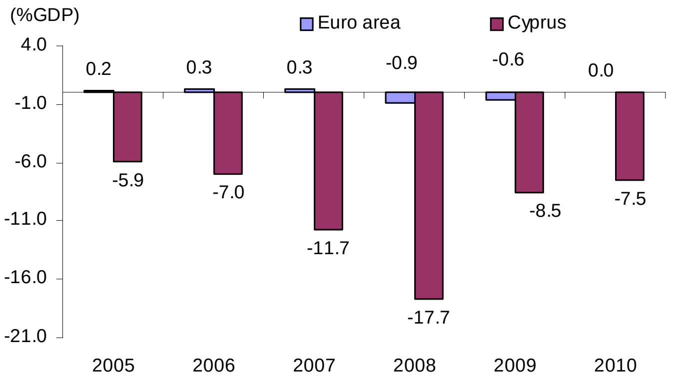
In line with our forecast of broadly stagnant GDP growth this year, we expect a slightly higher deficit in 2010 (around 6.5%-of-GDP) relatively to what the government expects.

Current account deficit improves due to domestic economic recession

The silver lining of the domestic economic slowdown is the sharp improvement being so far witnessed in the country's current account balance. Weak domestic demand led to a sharp contraction in imports last year, which more than outweighed a concomitants decline in exports as a result of the recession in main trade partner economies. After recording a whopping 17.7%-of-GDP deficit in 2008, the current account gap declined by 44% last year to reach €1.7bn or 8.5%-of-GDP. Some additional improvement is expected in the months and quarters ahead as the rebound in domestic demand is likely to lag that in trading-partner economies.

Figure 3

Current account balance improves sharply as a result of weak domestic demand



Sources: EU 2010 spring forecasts, national statistics, Eurobank EFG Research forecasts

Inflation picks up in recent months but a further spike from current levels likely to be caped by weak domestic demand

Annual domestic inflation averaged 0.3% last year, the lowest reading since 1965. Moreover, negative CPI readings were recorded in July-October 2009 on the back of weak demand-side pressures and favorable base effects. However, as the latter eventually faded, consumer price inflation resumed its uptrend, reaching in February 2010 a 16-month high of 2.88%yoy. Year-on-year inflation stood at 2.44% in April. We expect a further rise towards 3%yoy by the end of this year, primarily due to cost-push pressures.

High household indebtedness remains a concern…

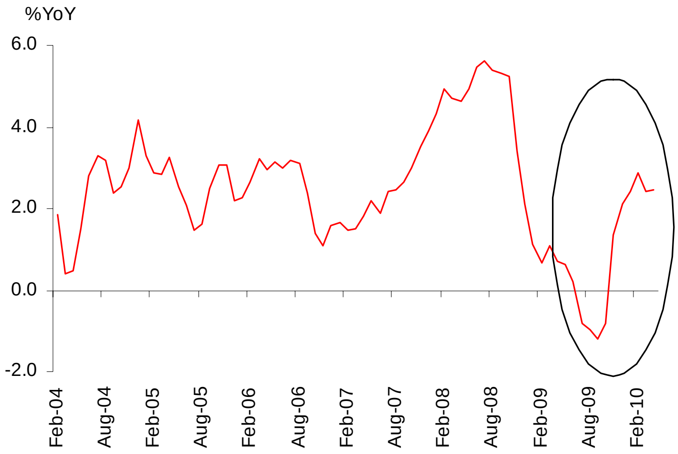
As a result of the deterioration in government finances, public debt is expected to increase in the coming years. At its SP the government expects public debt to breach the 60%-of-GDP threshold this year vs. a ratio of 56.2%-of-GDP recorded in 2009. Even so, the debt ratio is expected to remain well below the corresponding average euro zone figure, which the Commission expects to reach 84.7%-of-GDP over that period. The picture is very different in the domestic private sector, where total outstanding credit amounted to around 240%-of-projected-GDP in March. However, part of this figure may be affected by a number of foreign companies, termed as "Brass Plates"[4], registered in Cyprus but not physically located in the island and effectively not directly affecting the domestic economy. Even so, domestic households[5] remain highly indebted, accounting for ca 45% of the total amount of loans to domestic residents. Nonetheless, private sector NPLs have stabilized around levels of 4% over the last few months and currently do not seem to pose a significant risk for domestic banks.

…but sound domestic banking sector likely to cushion potential shocks

It is also worth noting that the domestic banking sector, with assets accounting for more than 800%-of-GDP[6], remains sound with capability to cushion potential shocks and with no direct exposure to toxic assets. This suggests limited credit-related risk. Banks' liquidity has somewhat tightened recently but remains at comfortable levels on the back of ample deposits boosted by the country's "tax haven" status. The overall loans-to-deposits ratio stood at 114% in March 2010[7]. Nevertheless, a high exposure of the banking system to the ailing real estate and construction sectors does pose as a lingering risk.

[4] Brass plates are companies that are located in Cyprus but do business outside the island. Most of these companies do not have staffed offices in Cyprus but their presence on the island is just a brass plate on a registered address.
[5] Loans to households are defined as the loans extended to domestic households and non-profitable institutions servicing households
[6] 874.6%-of-GDP as of June 2009, according to the Central Bank of Cyprus
[7] Loans to deposits ratio of domestic residents

Figure 4
Cyprus's CPI rebounds from lows touched in September 2009



Sources: National statistics

Worries over a slowdown in reunification talks after nationalist Dervis Eroglu wins Presidential election

The island of Cyprus has been divided since 1974 following a Turkish invasion. Turkish Cypriots declared independence in 1983 but have received diplomatic recognition only from Turkey, whereas the Greek Cypriot government is internationally accepted. Reunification negotiations have so far failed, with a UN blueprint in 2004 being voted down by Greek Cypriots. The latest round of talks began in September 2008. Greek President Demetris Christofias and former Turkish leader Mehmet Ali Talat had both signaled a strong will to reach a solution on the issue. However, the latter's defeat in April's Presidential elections to Turkish Cypriot nationalist Dervis Eroglu has raised concerns about the prospects of re-unification. Eroglu has said he will continue talks, with discussions expected to resume on the week of May 24. But he has signaled he is in favor of two independent states in the island, contradicting an earlier scenario to unite Cyprus under a federal overseer. Meanwhile, the Socialists' (EDEK) decision to quit the Greek Cypriot coalition government in early February amid disagreement over the President's handling of the reunification talks, is not seen having a significant impact on the domestic political landscape. The risk of early elections is limited as Cyprus has a presidential system of government with a strong executive. Peace negotiations are not seen affected by this incident either, as EDEK had long been in disagreement over the way the Greek Cypriot government managed the process.

Reunification is expected to boost medium-term growth

A potential reunification would likely bear tremendous gains for domestic economic activity in the island. This view has already been voiced by a number of government officials, including ECB Governing Council member and governor of Central Bank of Cyprus Athanasios Orphanides. Such a development would probably result to a wide-scale reconstruction of the island. It could boost real estate activity and tourism against a background of improved investor sentiment and a high number of inhabitants seeking housing in new buildings. The revocation of the trade embargo between Cyprus and Turkey could also assist economic activity significantly in both countries.

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