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www.eurobank.gr/research
research@eurobank.gr

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FOCUS NOTES: CYPRUS

Platon Monokroussos
Assistant General Manager
Head of Financial Markets Research
pmonokrousos@eurobank.gr

Focus - Cyprus

Sovereign borrowing needs and sources of funding over the programme period (and beyond)

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[1], 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.

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

Contribution by Cyprus	**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

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

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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. 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).

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.[2] 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.

Table 1.1 – Sovereign fuding 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 **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[3], 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.[4]

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[5] . 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.

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 (**Graph 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)

[2] The IMF has already signaled its intention to participate in the Cypriot bailout under the "normal access procedure".

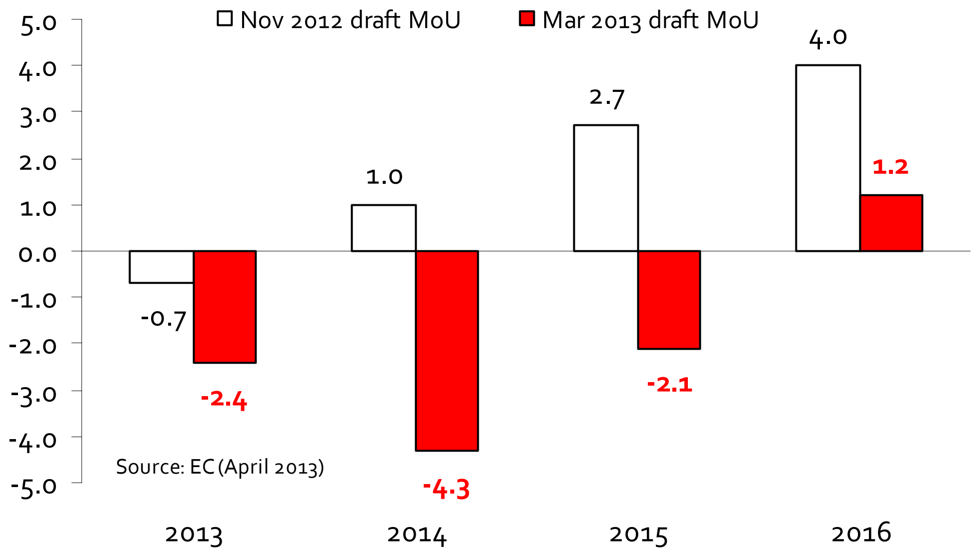
[3] European Commission, "Assessment of the actual or potential financing needs of Cyprus"; provisional draft, 9 April 2013.

[4] 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.

[5] 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.

Note that as part of the conditionality underlying the new draft MoU that was liked to the press in early April[6], 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 71/4ppts-of-GDP out of which ca 5ppts-of-GDP have been legislated in December 2012).

Graph 1 – General government primary balance (% of GDP)



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 like 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.

[6] http://www.tovima.gr/files/1/2013/04/12/Cyprus1.pdf

Research Team

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

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