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FOCUS NOTES: CYPRUS

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Final deal on Cyprus rescue package still pending

- **Certain delays encountered in *finalizing* an agreement on a financial aid package for Cyprus due to, among others, uncertainty over the size of bank recapitalization needs**
- **No final decision with official lenders expected before the February 2013 election**
- **Domestic banks increase dependence on ELA facility, amid tightened funding conditions, lack of eligible ECB collateral**
- **Domestic economy to remain in recession through to 2014; debt sustainability concerns on the rise**
- **External deficit dynamics improve, inflation pressures at bay as domestic economic downturn continues**

Draft MoU agreed at staff level, finalization of rescue package still pending

In June 2012, Cyprus announced its decision to officially request financial aid from the European Union and the IMF. The announcement came on the back of rising headwinds to the domestic banking system, whose total size in terms of assets is considered to be rather big relative to that of the domestic economy. The problems culminated mainly as a result to the sector's exposure to Greece trough its sovereign bond and loan portfolios. However, negotiations with the EC/ECB/IMF troika of official lenders have prolonged more than initially expected, with a final deal still pending.

Following a two-week troika visit to Cyprus in November 2012, the government said that a preliminary agreement on the terms of a Memorandum of Understanding (MoU) with official lenders was reached. A troika statement released shortly after read that significant progress was indeed made in the negotiations with domestic authorities. Yet, a final agreement was still pending and any further negotiations between the two parties would continue remotely.

According to the preliminary MoU leaked to the press in late November, the proposed programme will span four years, targeting a primary surplus of 4.0%-of-GDP by 2016 vs. an expected shortfall of ca 0.7% in 2013. It also envisions the implementation of fiscal adjustment measures worth of 7¼-of-GDP cumulatively over the period 2012-2016 (Table 1).

Table 1: Fiscal adjustment measures and primary balance targets envisaged in the preliminary draft MoU (Nov. 2012)

	fiscal adjustment measures (GDP%)	primary balance targets (GDP%)
2012	3	
2013		-0.7
2014	1.75	1.0
2015	1.50	2.7
2016	1	4.0
Total	7.25	

Source: MoU on Specific Economic Policy Conditionality, FinMin, Eurobank Research

The draft MoU focuses on three main pillars, namely safeguarding domestic financial sector stability, restoring fiscal prudence and promoting an ambitious program of structural reforms.

Delays in finalizing agreement with official lenders

A final agreement between the government and the troika on a bailout package for Cyprus is still pending, due to, among other reasons, lingering uncertainty regarding the exact size of bank recapitalization needs. The latter will be determined by the final results of a due-diligence exercise conducted by investment firm PIMCO, originally expected to be published in mid-January 2013. According a number of PIMCO preliminary findings leaked to the press last December, domestic banks' recapitalization needs under an extreme scenario are estimated at ca €10bn or nearly 50% of the country's GDP. This amount is in line with earlier press reports estimating the total size of the rescue package to amount to around €17.5bn, including up to €10bn for banks, €6bn for servicing public debt and €1.5bn for plugging other budgetary holes. With Cyprus's 2011 gross domestic product (at current prices) coming in at around €18bn, the financial aid package will amount to ca 100% of GDP, if the above figures are eventually vindicated.

In early January, national authorities called BlackRock to provide a separate assessment on the methodology PIMCO used to determine the domestic banking system's capital requirements. They have noted that the aim is not to oversee PIMCO, but to achieve a better understanding of the procedures used to evaluate the sector's recapitalization needs and to examine whether different results from those of PIMCO may be drawn. Reportedly, this procedure is being followed amid hopes that it may yield estimates for the bank recapitalization needs that fall at the lower end of PIMCO figures and thus, provide more flexibility in the negotiations with the troika (see analysis below).

No final bailout agreement is expected before the February 2013 elections

With domestic presidential elections approaching (first round due on February 17th and run-off a week later, in case that the first round is inconclusive), a final agreement is not expected before the polls. In support of the latter view, several euro area officials reportedly signaled in early January that they would prefer to wait for the Cypriot election outcome before the finalization of a deal. Along these lines, German Chancellor Angela Merkel suggested that negotiations over a rescue programme for Cyprus may take some time. She also said that "there can be no special conditions for Cyprus", implying that way that the deep reforms program, including privatization – which the incumbent Cypriot President staunchly opposes - must go through. Notably, Cyprus's main opposition Democratic Rally party (DISY) leader (and frontrunner for the post according to the latest opinion surveys) Nicos Anastasiades has indicated that he is in favour of a swift finalization of the deal.

Also raising some uncertainty regarding the timing of a final agreement, recent international media reports cited German official sources as voicing doubts over whether Bundestag is ready to endorse a bailout for Cyprus, in view of lingering financial transparency and money laundering-related concerns. These voices came from deputies from both the coalition government and the opposition Social Democrats (SPD). Notably, the German government may need to rely on SPD backing in order to secure parliamentary support for the Cypriot bailout.

Disagreements within the troika are another issue which may cause potential delays. Reportedly, the IMF is calling for a write-down of Cypriot public debt before agreeing to participate in the country's bailout. The reasoning cited in international media for such a request by the Fund is that Cyprus's debt will rise to unsustainable levels as a result of the rescue loan. On the other hand, European officials had in the past suggested that the Greek PSI was a unique case and that it would not be repeated in other sovereign bailouts. Furthermore, several European Union officials explicitly dismissed the idea of a Cypriot debt haircut. However, a German government spokesman suggested recently that all options to bring Cyprus's debt to sustainable levels need to be examined.

Russia's involvement on Cyprus's bailout is yet to be determined. As a reminder, the Cypriot government appealed to Russia for another loan of €5bn last year, after securing €2.5bn from the same lender in late 2011, without any strict conditionality attached. However, the more recent request appears to have been placed on the backburner. That said, Russian government officials have suggested that any new financial aid to the country would only be granted in partnership with the troika. Along these lines, German Finance Minister Wolfgang Schäuble urged Russia in mid-January to contribute to Cyprus's financial aid deal. Against this background, we would not expect a final announcement on the issue before the 4 March 2013 Eurogroup, at the earliest.

Government said it secured necessary funding through to March 2013

With a final decision on Cyprus's bailout programme still some way off, the Cypriot government highlighted recently that it has secured the necessary funding to meet its immediate financing needs until March 2013. As a reminder, Cyprus has been unable to access international capital markets for more than a year now. Notably, the yield of the 4.625% February 2020 government bond currently stands at around 12%, up sharply from levels around 6% in late 2010. Yet, the government has so far managed to cover its financing needs through issuance of Treasury bills (bought mainly by domestic banks) and short-term loans provided by semi-state organizations, such as the Electricity Authority of Cyprus (EAC), the Cyprus Telecommunications Authority (CyTA) and the Cyprus Ports Authority. Thankfully, the first major bond redemption will not come before early June, when a €1.4bn issue expires. Another debt maturity of €715mn is due in the month after (Table 2).

Table 2: Government bond redemptions in 2013

Date of Redemption	Redemption Amount (in mn EUR)
Jan-13	159
Apr-13	2
Jun-13	1,415
Jul-13	715
Oct-13	1

Source: Bloomberg, Eurobank Research

Banking sector faced with headwinds

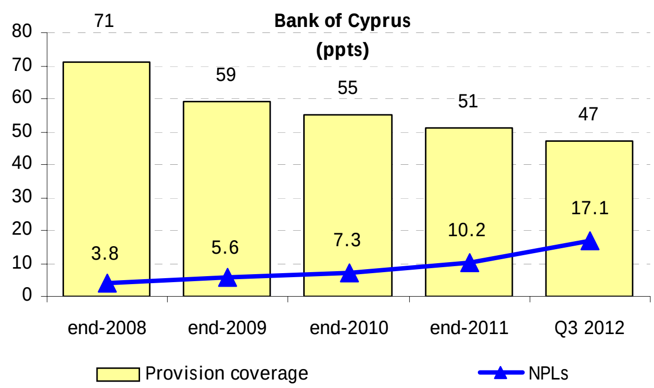
Among the main risks to the domestic economy stemming from Cyprus's banking system arguably lies in the face of its large size. According to the latest available data (December 2011), total banking sector assets amounted to ca €146.2bn or 820%-of-GDP. In addition, the sector is highly concentrated with the Bank of Cyprus (BoC), Cyprus Popular Bank (CPB), Hellenic Bank and the Greek subsidiary of Alpha Bank controlling a 53% share of the total lending market (Stability Programme 2012-2015).

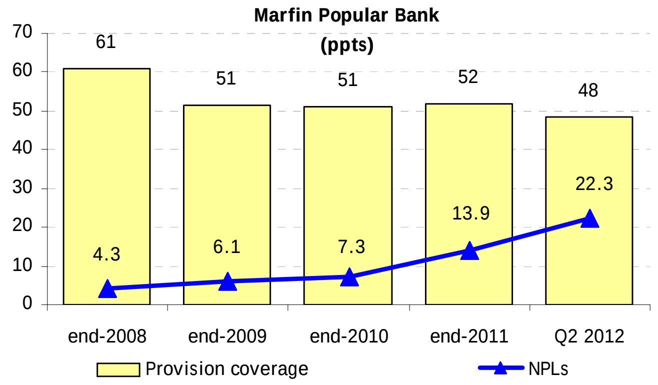
Although the domestic financial system managed to weather well the global financial crisis, it encountered substantial losses (in excess of €4.5bn, or 25%-of-GDP) as a result of the Greek debt exchange (PSI), with its asset quality deteriorating both domestically and abroad. As of December 2011, locally-based banks had in their books around €21.8bn of direct loans to Greek customers (SP 2012-2015). They have also encountered substantial losses as a result of their exposure to the ailing domestic real estate sector and rising non-performing loans.

Indicatively, the two largest domestic banks, Bank of Cyprus and Cyprus Popular Bank, posted respective net losses to the tune of €211mn and €1.09bn in the first three quarters of 2012, as a result of the Greek debt restructuring (PSI) and higher provisions for non-performing loans. NPLs for these two banks have increased significantly over the last four years (Figure 1). This trend has gained momentum since mid 2011 and, more recently, is has been aggravated by rising NPLs in the Greek market. It is worth noting that loans to Greek residents account between 34% and 44% of the total loan portfolios of the aforementioned banks (Tables 3&4).

In order to align their capital position with the European Banking Authority (EBA) recommendations, Bank of Cyprus and Cyprus Popular Bank had to meet a 9% core Tier 1 capital ratio by June 30, 2012. To fulfill the said target they had to plug respective capital shortfalls of €1.56bn and €1.971bn. The banks were not able to fully cover these amounts on their own means, in spite of undertaking a series of actions. They proved to be short of a cumulative amount of €2.3bn (€0.5bn and €1.8bn, respectively) as their regulatory capital was depleted by the Greek debt exchange. As a result, they sought financial assistance from the government. In June 2012, the government bailed out CPB, injecting €1.8bn into the bank. Reportedly, the State now owns around 84% of CPB's shares. Bank of Cyprus's request for official assistance will be discussed in the context of the recue package with the troika.

Figure 1: Bank of Cyprus & Cyprus Popular Bank NPLs evolution





Source: Quarterly financial earnings reports, Eurobank Research

Table 3: Geographical breakdown of BoC loans (outstanding amounts as of 30.09.2012)

	(mn EUR)	YoY%	Share of total
Cyprus	14,883	1%	53%
Greece	9,472	-7%	34%
Russia	2,076	5%	7%
UK	879	-14%	3%
Ukraine	342	17%	1%
Romania	574	-10%	2%
BoC (total)	28,226	-2%	100%

Source: BoC, Eurobank Research

Table 4: Geographical breakdown of CPB net loan portfolio (outstanding amounts as of 30.06.2012)

	(mn EUR)	YoY%	Share of total
Cyprus	10,600	3%	46%
Greece	10,200	-21%	44%
Other	2,300	NA	10%
CPB (Total)	23,100	-10%	100%

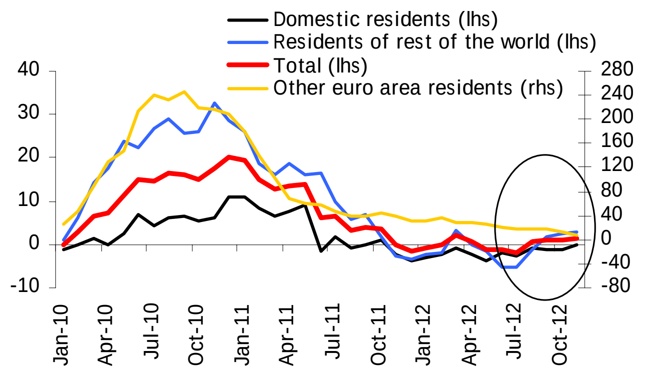
Source: CPB, Eurobank Research

With Cyprus's nominal GDP currently amounting to around €18bn, Bank of Cyprus and Cyprus Popular Bank bailouts would amount to a sizeable 13%-of-GDP. This proved to be beyond the State's financial capacity, resulting in the government requesting financial assistance from official lenders. To complicate things further, recapitalization needs for the two largest domestic lenders may prove higher than estimated earlier. According to an EBA report, CPB needed another €1.125bn as of June 2012 in order to increase its core Tier 1 ratio to the regulatory threshold of 9.0%. Likewise, the BoC exhibited a €730mn capital shortfall, with a core Tier 1 ratio at 6.9%.

Another potential vulnerability for the domestic banking system lies in the face of the relatively high private sector indebtedness. Private sector loans reached €47.54bn in November 2012, corresponding to 265.5%-of-projected-GDP. Nonetheless, it is worth noting that domestic households' net financing position remains positive and there is a strong cultural component in their borrowing practices.

A significant slowdown in domestic bank deposits is being evident since late 2010, amid heightened worries over the domestic macroeconomic outlook. Nonetheless, the year-on-year growth of total (i.e., resident + non-resident) deposits to domestic banks was marginally positive in November 2012 (latest available data, Figure 2). Also, on a rather positive note, the loans to deposits ratio remains close to 100% (102.3% in November 2012).

Figure 2: YoY% changes in bank deposits



Source: CBC, Eurobank Research

Table 5: Change in loans & deposits end-2010 vs. Nov. 2012

	Dec-10		Nov-12	
	mn EUR	YoY%	mn EUR	YoY%
Total loans	61,475.1	9.3	71,520.0	4.3
Total deposits	69,939.7	20.2	69,941.6	1.3
Loans/DepositsRatio	87.9%		102.3%	

Source: CBC, Eurobank Research

Banks increasingly resort to ELA facility amid tight funding conditions, lack of eligible ECB collateral

Financial conditions worsened and Cyprus's sovereign credit ratings came under significant pressure since late 2010, mainly as a result of the domestic banking sector's exposure to Greece and deteriorating fiscal dynamics. Following a series of downgrades (Table 6) the country lost access to international credit markets. In June 2012, Fitch was the last of the three major rating agencies to downgrade Cyprus's long-term foreign currency bonds to non-investment grade status. Shortly after the latter downgrade, the European Central Bank announced that the Republic of Cyprus bonds were no longer eligible as collateral for the domestic banking sectors' refinancing operations via its regular liquidity facilities. Note that the ECB's minimum eligibility criterion is for at least one of the major ratings agencies to value government bonds as investment grade.

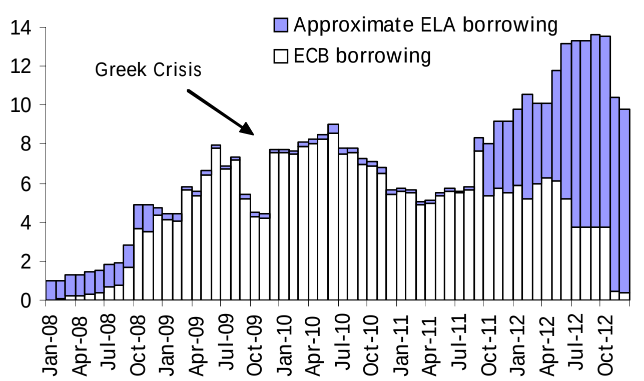
Table 6: L-T Foreign Currency Credit Ratings

	End-2010 Rating	Current Rating	Cumulative change as of Jan. 2013 since end-2010	Date of last rating action	Last rating action	Current outlook
Fitch	AA-	BB-	9-notches down	21/11/2012	2-notches down	Negative
S&P	A	CCC+	11-notches down	20/12/2012	2-notches down	Negative
Moody's	Aa3	Caa3	15-notches down	10/1/2013	3-notches down	Negative

Source: Bloomberg, Eurobank Research

In view of the tightened liquidity conditions and the lack of adequate collateral for refinancing through the regular ECB liquidity facilities, Cypriot banks have increasingly relied to more expensive funding options, such as the Emergency Liquidity Assistance (ELA) (Figure 3). Notably, ELA borrowing increased by approximately €3.7bn in H2-2012, while the outstanding amount of ECB lending fell by €5.7bn over that period.

Figure 3: Estimated bank borrowing via the ECB and the ELA facility (outstanding amounts in €bn)



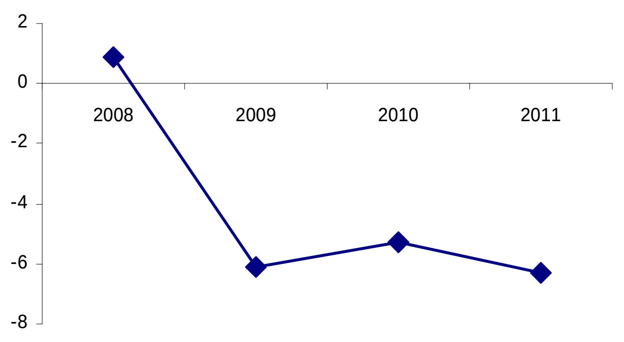
Source: CBC, Eurobank Research

Under the ELA facility, Cypriot banks can obtain necessary funding from the Central Bank of Cyprus (CBC). Subject to certain criteria, the ELA facility accepts collateral that may not be eligible for the standard refinancing operations of the ECB and thus, it provides the necessary liquidity to domestic credit institutions. As depicted in Figure 3, total bank borrowing peaked at around €13.6bn in September 2012, with approximately €9.9bn of that amount coming from the ELA facility and the rest from the ECB. The ELA facility is expected to remain the main source of funding for the domestic banking system, at least until the troika money arrives.

2012 budget deficit to significantly exceed the 2.6%-of GDP revised target

A notable deterioration in Cyprus's public finances has been witnessed in the recent few years, with the general government balance swinging from a small surplus (0.9%-of-GDP) in 2008 to deficits in excess of 5.0%-of-GDP in each single year since then. This deterioration came mainly on the back of intensifying structural weaknesses on the spending side, including, among others, sharp hikes in public wages and pensions as well as untargeted social transfers (Figure 4). Lower tax receipts from the ailing real estate sector have been also weighing on State revenues during the aforementioned period. Despite fiscal austerity measures adopted in the last couple of years, the FY-2012 general government budget deficit is seen only marginally narrower relative to the prior year *i.e.,* 5.2%-of-GDP (Finance Ministry forecast) vs. 6.3%-of-GDP in 2011 and double the 2.6%-of-GDP target envisioned in the country's Stability Programme (SP 2012-2015).

Figure 4: General government balance (% of GDP)



Source: Ministry of Finance, Eurobank Research

According to the latest cash data for the consolidated accounts of the central government and administered funds (which exclude local governments and social security funds, but usually show little discrepancy relative to the corresponding general government figures), the budget deficit came in at €744mn or 4.19%-of-projected GDP in the first eleven months of 2012 (Table 7). The breakdown of the data showed that revenues marginally declined over that period, while expenditure fell by 1.7%yoy. The aforementioned budget shortfall already exceeded by a wide margin the full-year 2012 deficit target of 2.6%-of-GDP for the general government envisaged in the Stability Programme 2012-

2015. It also represents only a tiny improvement from a 4.6%-of-GDP shortfall registered over the corresponding period a year earlier. Note that the general government balance recorded a deficit of 6.3%-of-GDP in 2011. Last year's fiscal slippage can be mainly attributed to the underperformance of tax collections as a result of the domestic recession, which has proven to be deeper than initially expected (Eurobank estimate for 2012 real GDP growth: -2.5% vs - 0.5% assumed in the Stability Programme 2012-2015). The slippage can be also explained by certain expenditure overruns related to *e.g.* increased unemployment benefits and higher interest payments (+15% yoy in the 11-month period to November 2012). On a more positive note, the overall primary balance of the central government and administered funds shrunk to nearly half of last year's €315.5mn.

Table 7

CONSOLIDATED ACCOUNTS OF CENTRAL GOVERNMENT AND ADMINISTERED FUNDS ON A CASH BASIS (in thousands of Euro)	Jan.-Nov 2011	Jan.-Nov 2012	YoY% 11M 2012/11M 2011
REVENUE AND GRANTS	5,705,795	5,677,994	-0.49
REVENUE	5,608,674	5,606,051	-0.05
TAX REVENUE	4,907,161	4,946,350	0.80
DIRECT TAXES	1,709,702	1,755,350	2.67
INCOME TAX	1,184,590	1,160,295	-2.05
OTHER DIRECT TAXES	525,112	595,055	13.32
INDIRECT TAXES	2,241,956	2,270,501	1.27
IMPORT DUTIES	19,556	29,914	52.96
OTHER INDIRECT TAXES	2,222,400	2,240,587	0.82
Excises	596,596	559,044	-6.29
V.A.T.	1,338,087	1,355,190	1.28
Other	287,717	326,353	13.43
SOCIAL SECURITY CONTRIBUTIONS	955,504	920,498	-3.66
NON TAX REVENUE	701,513	659,701	-5.96
GRANTS	97,121	71,943	-25.92
EXPENDITURE	6,533,124	6,422,289	-1.70
CURRENT EXPENDITURE	6,132,874	6,142,440	0.16
WAGES AND SALARIES	1,666,353	1,645,815	-1.23
OTHER GOODS AND SERVICES	448,815	432,067	-3.73
SUBSIDIES	62,163	85,181	37.03
INTEREST PAYMENTS	511,830	589,012	15.08
SOCIAL SECURITY PAYMENTS	1,163,675	1,285,297	10.45
PENSION AND GRATUITIES	470,044	550,900	17.20
SOCIAL PENSION	53,067	54,575	2.84
OTHER CURRENT TRANSFERS	1,664,900	1,431,330	-14.03
UNALLOCABLE	92,027	68,263	-25.82
CAPITAL EXPENDITURE	400,250	279,849	-30.08
INVESTMENT	400,250	279,849	-30.08
CAPITAL TRANSFERS	0	0	0.00
OVERALL BALANCE (€ '000)	-827,329	-744,295	
OVERALL BALANCE (% of GDP)	-4.60	-4.19	
PRIMARY BALANCE (€ '000)	-315,499	-155,283	

Source: Ministry of Finance, Eurobank Research

2013 Budget passed in parliament

Last December, the 2013 Budget and the updated Medium Term Fiscal Plan (2013-2015) were approved by the Cypriot Parliament. The documents, submitted to parliament in late November, included, among others, tax increases, reductions in civil servants' headcount, cuts in social transfers and scaled reductions in wages and pensions in the public and the broader public sector, in line with the troika's suggestions under the draft Memorandum of Understanding (Nov 2012). Among the main revenue-generating measures were:

- increase from 0.095% to 0.110% on a levy applied to domestic bank deposits
- introduction of a 20% tax on gains distributed to the winners of Greek Organization of Football Prognostics (OPAP) and National Lottery games as of 2013
- a 1ppt increase in the main VAT rate to 18% in 2013 and a further 1ppt increase in 2014
- a hike to 9% from 8% in the reduced VAT rate in 2014
- increase in motor fuel consumption tax by 7 cents in 2013 and by an additional 5 cents in 2014
- increase of excise duties on tobacco and alcohol products as of 2013
- abolition of all exceptions currently applied to an annual corporate levy of €350

Expenditure-side measures include, among others:

- scaled reductions between 6.5% and 12.5% in the 2012 emoluments of public and broader public sector pensioners and employees and an additional flat rate cut of 3% in 2014 on wages and pensions of the broader public sector
- extension of a suspension applied to the cost-of-living-allowance (COLA) for all broader public sector employees until a reform of the COLA framework comes into effect
- extension of a wage freeze in the public and the broader public sector
- reduction in public sector headcount by at least 5,000 in 2012-2016
- freeze in the hiring of new hourly-paid personnel and enhanced mobility within and across ministries and other government entities
- reduction in social transfers as of 2013

- reduction in allowances for public and broader public sector employees

- under the Government Pension Scheme, a freeze to public sector pensions will apply along with an increase in the statutory retirement age by 2 years

Central government revenues are expected to increase by 1.3%yoy to €5.860bn this year, following an expected rise of 1.6%yoy in 2012. On the spending side, government outlays are anticipated to decrease by 5.8%yoy to €7.014bn. In view of the government's renewed consolidation efforts under the preliminary Memorandum of Understanding agreed in November 2012, a further improvement in Cyprus's fiscal position is anticipated through to 2016, with the general government primary position seen reaching a surplus of 4% of GDP at the final year of the aforementioned period (Table 1).

Public debt sustainability concerns on the rise

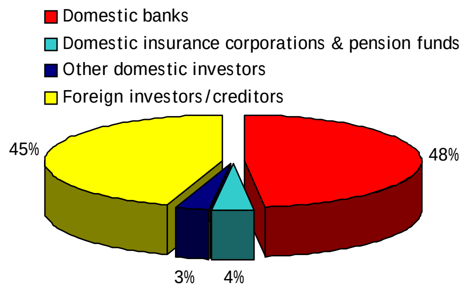
The notable deterioration in the government accounts witnessed over the last few years has prompted a sizeable increase in the public debt-to-GDP ratio, which reached 71.1% at the end 2011 from nearly 50% at the end of 2008. A further increase to 83.3%-of-GDP was recorded in Q2-2012, partly as a result of the recapitalization of the Cyprus Popular Bank. The 2013 Budget forecasted a debt-to-GDP ratio of 85.8% at the end of last year, well above the 60% Maastricht Treaty threshold.

Market concerns about Cyprus's public debt sustainability have recently been on the rise, especially since the debt ratio is expected to increase further in the period ahead as a result of the lingering economic downturn and the pending troika bailout. According to the 2013 Budget (and the updated medium-term budgetary framework), the gross public debt ratio is expected to peak at 95.6% in FY-2014. Under an adverse scenario (incorporating, among others, higher bank recapitalization needs vs. the baseline), the government sees the debt ratio peaking in 2014 at levels below 140%, before embarking on a descending path, easing towards 100% by 2020.[1] Yet, in its latest assessment of Cyprus's economic prospects released in early January, Moody's warned that the country's debt-to-GDP ratio may rise above 154% by 2015 and assigned a 50% probability to a debt restructuring scenario involving private-sector bondholders (PSI).

Along these lines, a number of recent press reports[2] suggested that the IMF has called for a haircut on private creditors before it joins a bailout deal.

From its part, the Cypriot government does not currently seem to favor a debt restructuring, on the basis that: **(i)** domestic banks presently possess a significant chunk of public debt (ca 48% of total debt excluding bank recapitalization bonds) and thus, a sovereign debt write-down would translate into even higher recapitalization needs for the sector (Figure 5); **(ii)** a debt write-down could also take a heavy toll on domestic insurance companies and pension funds; and **(iii)** a sovereign debt restructuring would be rather complicated to enforce from a legal standpoint and it could also involve significant reputation costs, endangering future market access.

Figure 5: Breakdown of public debt ownership



Source: Statistical Service, CBC, Eurobank Research

According to the government, a number of potential factors/strategies that could mitigate debt sustainability concerns include**:** **(i)** concessional terms on ESM loans; **(ii)** a 5-year maturity extension (to FY-2021 with principal payments beginning in 2018) of a €2.5bn loan provided to Cyprus by Russia in late 2011 (given the close relations between the two countries, the request is expected to receive a positive response); **(iii)** proceeds up to €1bn until 2016 through the divestment of assets and other sources; **(iv)** €2bn expected revenue from the sale of government stakes in the banking sector; **(v)** interest income from hybrid instruments; **(vi)** wealth fund; and **(vii)** lower refinancing needs.

A direct recapitalization of the domestic banking system from the ESM, once the Single Supervisory Mechanism for euro area banks is in place, could also lighten the country's future debt burden *i.e.,* by removing the recapitalization package from the government balance sheet.

[1] http://www.mof.gov.cy/mof/mof.nsf/All/EE394E0941B2A9FBC2257AEF0043A224/$file/newCyprus%20economydebt%20sustainability.pdf

[2] e.g. see http://in.reuters.com/article/2012/12/20/us-cyprus-imf-minister-idINBRE8BJ13C20121220

However, the conditions for direct bank recapitalization from the ESM are not yet in place and several Member States including Germany, Netherlands and Finland, have reportedly opposed the mechanism's retrospective application.

Note here that, the final figure for the total estimated bank recapitalization need is of outmost importance in determining the size of the pending bailout package and thus, the projected evolution of the country's debt ratio. It is also worth noting that, according to press reports, the PIMCO baseline scenario estimates the sector's financial requirements to be around €6.5bn.The latter figure is 20ppts-of-GDP less than that reportedly estimated under the PIMCO adverse scenario (€10bn).

Domestic economy to remain in recession through to 2014

For a technical standpoint, the Cypriot economy entered into recession in Q4-2011, registering a negative quarter-on-quarter GDP growth reading for a second quarter in a row. Real output shrunk by a further 2.1% on an annual basis over the first nine months of last year. More specifically, domestic demand contracted by 7.6%yoy in the 9 months to September 2012, as private consumption declined by 2.7%yoy on the back of heightened macro uncertainty, deteriorating labour market conditions and fiscal austerity (general government expenditure down by 2.3%yoy over that period). Elsewhere, investments plummeted by 21.9%yoy over the first nine months of the year, weighed down by tightened credit conditions and weak investor confidence. On a more sanguine note, the external sector was a positive contributor to overall output growth in January-September 2012, as real exports increased by 2.9%yoy, primarily thanks to strong revenue from tourism, while imports shrunk by 9.2%yoy reflecting weakened domestic demand dynamics.

The domestic economy is expected to remain in recession through to 2014, against a macro backdrop characterized by weak domestic demand, tightened credit conditions and fiscal austerity. Net exports will likely continue providing a partial offset to the GDP downturn. Tourism revenue, which accounted to more than 10%-of-GDP in January-September 2012, is anticipated to continue faring well in the months and quarters ahead, supported by strong inflows from Russia and other high-growth countries/regions. A number of government initiates to promote Cyprus's tourism product in international markets and the lingering political instability in the Middle East are additional factors favoring Cyprus's appeal as an attractive destination for foreign visitors.

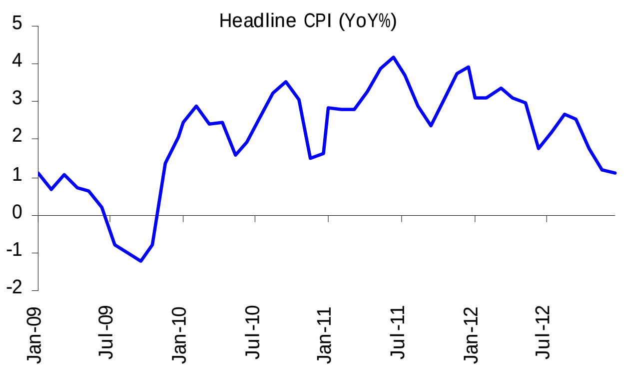
Looking further ahead, the domestic economy is likely to stage a gradual improvement from 2015 onwards, as external conditions improve and the impact of fiscal austerity is progressively absorbed. On the latter point note that the fiscal package presented in the November 2012 draft MoU envisages a front-loaded implementation profile, with 4.75ppts-of-GDP worth of austerity measures being applied in 2012-2014 and the remaining 2.5%-of-GDP in 2015-2016. From a longer-term perspective, potential drivers of domestic growth may also include the implementation of structural reforms and infrastructure development for the utilization of gas reserves.

Macroeconomic imbalances on the mend

The domestic economic downturn is facilitating a speedy adjustment in a number of *once-acute* macro imbalances, including inflation and the external deficit. Specifically, Cyprus's CPI hit a 3-year low of 1.1%yoy last December (Figure 6), bringing full-year inflation down to 2.4% from 3.3% in 2011. Weakened domestic demand dynamics and the waning impact of the 2011 electricity price increases are among the main culprits behind the recent fall in domestic inflation. The impact of a 2ppts increase in the main VAT rate to 17% that came into effect in March 2012 and recent changes in the weights of the CPI index appear to have been having only a limited impact. Despite further scheduled increases in the main VAT rate as well as in indirect taxation on tobacco, alcohol and oil products in 2013, we anticipate weakened domestic demand to keep inflation pressures at bay and we forecast respective declines in the annual CPI to 1.5% and 1% this year and the next.

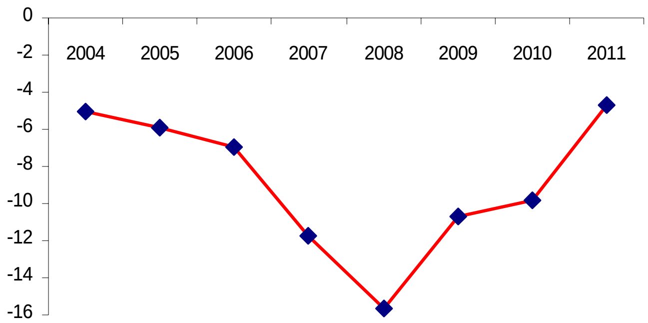
In a similar fashion, the current account deficit (as percent of GDP) shrunk to 4.7% in 2011 and to an estimated 4.5% in 2012 (Eurobank Research) from a lifetime peak of 15.6%-of-GDP recorded in 2008. For the current year, we expect a further current account adjustment to 2.0%-of-GDP.

Figure 6: Weak domestic demand dynamics keep inflation pressures at bay



Source: Statistical Service, CBC, Eurobank Research

Figure 7: External position continues to adjust (current account as % of GDP)



Source: Statistical Service, CBC, Eurobank Research

Timeline of key data and events in the coming months

- January 14 – 1ppt increase in main VAT rate, to 18%
- January 15 – Initial deadline for final PIMCO results
- January 18 – Updated deadline for announcement of final PIMCO results
- January 21- Eurogroup
- February 11 – Eurogroup
- February 17 – Presidential elections
- February 24 – Presidential elections run-off
- March 1 – New President takes office
- March 4 – Eurogroup
- April 11 – Eurogroup
- May 13 – Eurogroup
- June 3 – €1.42bn worth of debt mature
- June 20 – Eurogroup
- July 7 - €715mn worth of debt mature

Cyprus: Realisation and Eurobank EFG Forecasts						
	2008	2009	2010	2011	2012	2013
Real GDP (yoy%)	**3.6**	**-1.9**	**1.3**	0.5	-2.5	-3.5
Domestic Demand	8.0	-7.0	1.9	-2.8	-8.2	-9.2
Final Consumption	7.4	-4.6	1.4	0.1	-4.5	-7.0
Private Consumption	7.8	-7.5	1.5	0.2	-5.0	-5.5
Government Consumption	6.1	6.8	1.0	-0.2	-3.0	-12.0
Gross Fixed Capital formation	6.0	-9.7	-4.9	-13.1	-23.0	-15.0
Exports	-0.5	-10.7	3.8	3.3	2.5	3.5
Imports	8.5	-18.6	4.8	-4.1	-10.0	-8.5
Inflation (yoy%)						
HICP (annual average)	4.4	0.2	2.6	3.5	3.1	1.5
HICP (end of period)	1.8	1.6	1.9	4.2	1.5	1.2
Labour market						
Unemployment rate (%)	3.3	6.0	5.4	8.9	NA	NA
Fiscal accounts (GDP%)						
General Government Balance	0.9	-6.1	-5.3	-6.3	-5.5	-4.0
Gross Public Debt	48.9	58.5	61.5	71.1	86.0	95.0
External accounts (GDP%)						
Current Account	-15.6	-10.7	-9.8	-4.7	-4.5	-2.0
Banking sector developments						
Total loans (yoy%)	32.1	9.7	9.3	11.9	NA	NA
Total deposits (yoy%)	6.8	3.8	20.2	-1.6	NA	NA
External debt						
CDS spreads	147.5	94.0	231.1	1,012.4	1,037.7	NA

Source: National Authorities, Bloomberg, Eurobank Research

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