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Trip Notes: Cyprus

Key notes from our recent trip to Nicosia: October 18th

Earlier this month, we travelled to Nicosia where we met with high-level officials from the CBC, the Finance Ministry, as well as market participants from the domestic financial sector. The present note attempts to offer our readers a cohesive overview of current conditions in the domestic economy and markets and the outlook ahead.

Key points:

- **Timid economic recovery underway driven, primarily, by the services sector; GDP growth seen marginally positive this year, with small acceleration expected in 2011**
- **The general government budget deficit is expected to reach levels around 6%-of-GDP in 2010, broadly in line with last year's outcome**
- **The 2011 draft budget targets a deficit of 5.4%-of-GDP, which is higher than that envisioned in the March 2010 stability program (4.5%-of-GDP). The government is considering a number of measures to fill the incipient gap, but no final decision has been announced yet**
- **Structural problems on the spending side of the general government budget need to be addressed on a more permanent basis**
- **Specifically, addressing a large (and rapidly growing) public-sector wage bill and eliminating past practices of broadly untargeted social transfers remain key policy challenges in an environment of increased market emphasis on medium-term fiscal sustainability**
- **Current account improves substantially as weak demand weighs on imports**
- **Domestic banking system strong enough to address future challenges**

Cyprus: Realisation and Eurobank EFG Forecasts				
	2008	**2009**	**2010F**	**2011F**
Real GDP (yoy%)	3.6	-1.7	0.5	1.5
Final Consumption	7.9	-1.2	-0.2	1.4
Gross Capital formation	10.3	-28.5	6.5	4.2
Exports	-2.1	-11.8	-0.5	3.5
Imports	8.0	-19.8	0.5	4.0
Inflation (yoy%)				
CPI (annual average)	4.7	0.3	2.9	3.6
CPI (end of period)	2.1	2.1	3.8	3.5
Fiscal accounts (GDP%)				
General Government Balance	0.9	-6.0	-6.0	-5.4
Gross Public Debt	48.4	56.2	61.5	65.0
External accounts (GDP%)				
Current Account	-17.7	-8.5	-5.0	-5.5

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

Timid economic recovery underway driven, primarily, by the services sector

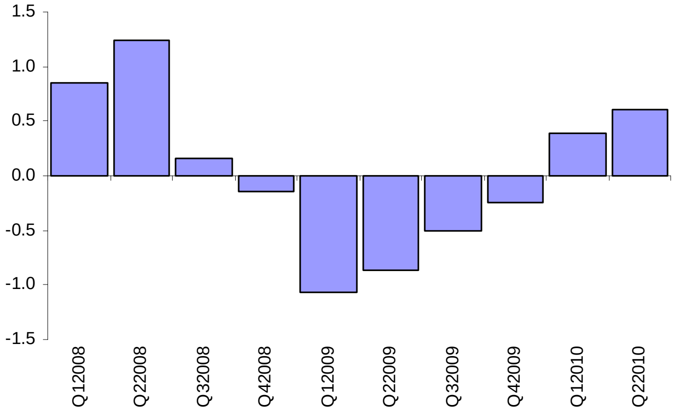
The Cypriot economy is showing preliminary signs of a timid recovery, after last year's recession, which saw annual GDP growth contracting for the first time in more than three decades. On a quarterly basis, GDP growth returned to a positive territory in Q1:2010 (+0.4%) following five consecutive negative readings, with domestic output rising by a further 0.6% in the second quarter. The latter pushed annual GDP growth to 0.5% in Q2, though for the period January-June 2010 as a whole, real output contacted by -0.4% compared to the first half of 2009. The gradual economic recovery appears to be primarily driven by an improvement in the services sector. From the production side, the main upside drivers in the first half of this year included: **a)** financial intermediation, renting and business activities (+1.3% yoy) and **b)** public administration & defense, education, health & social work and other services (1.5% yoy). Taken together, these added ca 0.6ppts to real GDP growth in H1 2010. Agriculture, hunting, forestry & fishing also exerted a positive contribution – for the first time since Q12008 - to the tune of 0.1ppts. In spite of their improvement relative to Q4:2009, when the recession reached its trough, construction and the wholesale & retail trade sectors contracted by 4.6%yoy and 2.6%yoy respectively in H1, subtracting ca 1ppt from GDP growth. Furthermore, respective declines of 0.8%yoy and 0.6%yoy in the mining, quarrying, manufacturing, electricity, gas & water supply sector and in import duties & VAT cumulatively curbed real GDP growth by a further 0.1ppt.

From the expenditure side, all components remained a drag on economic growth in January-June 2010, with the exception of gross capital formation which jumped 8.5%yoy, primarily thanks to higher inventories. Gross investments added ca 1.6ppts to overall growth over that period. Final consumption remained in contractionary territory in the first two quarters of the year, registering a 1.8%yoy decline and subtracting 1.8ppts from GDP growth. On a less negative note, a gradual improvement is consumption dynamics is visible since Q4:2009, when consumption expenditure experienced its deepest contraction in decades as domestic households were hit hard by tightened domestic credit and deteriorating labor market conditions. Net exports' contribution turned negative in Q2, after six consecutive quarters of positive input, as imports recovered at a faster pace than exports. Over the January-June period, the external sector slashed 0.2ppts from real GDP growth, as a result of a 2.2%yoy drop in exports, which outpaced a 1.4%yoy decline in imports.

Higher-frequency indicators point to an anemic recovery ahead

A modest revival in the tourism industry is supporting domestic economic activity so far this year, thanks to rebounding trade-partner economies. Official data is already showing that the sector is on a gradual mend. In detail, revenues rose by 2.7%yoy in August, pushing the annual rate of increase to 1.7% over the first eight months of the year. Meanwhile, arrivals bounced 4.7%yoy in September, and they are up 1.3%yoy since the beginning of the year. This improvement follows full-year declines of 16.7%yoy and 10.9%yoy, in revenues and arrivals, respectively in 2009. Note also that the recovery in the sector would have been stronger had it not been for the volcanic ash which disrupted flights across Europe in the second quarter.

Figure 1: QoQ GDP growth has turned positive since the beginning of the year, following 5 consecutive quarters of negative growth

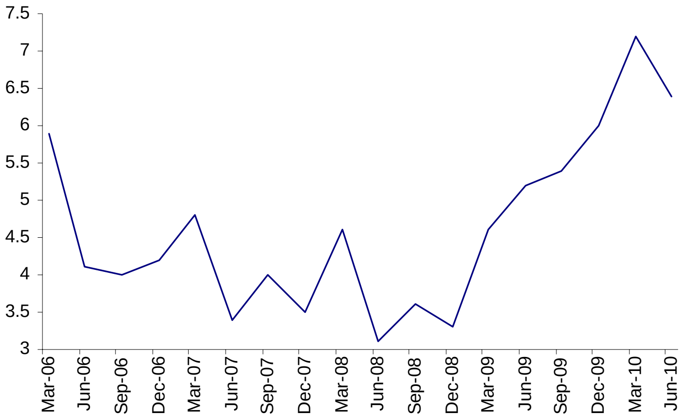


Source: National Statistics

In the retail sector, the volume of retail sales rose by 0.9%yoy and 1.7%yoy in June and July, respectively, pushing the respective year-to-July reading to -0.6%yoy, from -3.7%yoy over the same period a year earlier. The value of credit card purchases made by domestic residents rose by 3%yoy over the first seven months of the year, with September alone marking a 2%yoy rise. The data comes on the heels of a 3%yoy full-year decline in 2009, signaling a potential stabilization in domestic consumption dynamics. Annual credit growth to the private businesses and households has embarked on an uptrend since October 2009 when a trough was reached in loan activity, with the household sector appearing to fare relatively better. Meanwhile, the most recent labour force survey showed that the rate of unemployment eased to 6.4% in Q2, after reaching a multi-year peak of 7.2% in Q1. An improvement was also observed in August's business and economic sentiment indicators, which gained on the back of rising sentiment in the services sector and improving business conditions. In these lines, the latest trade data showed imports growing by 11%yoy year-to-August, following an 18%yoy decline in the year 2009 as a whole. On a less positive note, the total number of registrations of motor vehicles dropped 15%yoy in the January-September period.

The construction and real estate sectors, which were hit hard by the global economic crisis, have yet to show concrete signs of sustainable rebound. Although the number of building permits, considered as a leading indicator of future construction activity, rose by 1.2%yoy in January–July, their value fell by 6.0%yoy, comparing with a smaller decline (-3.1%yoy) last year. Meanwhile, the number of dwelling units continued to decline at nearly double-digit rates. Elsewhere, industrial production fell by 4.8%yoy in July pushing the overall output in the sector down to -1.4%yoy over the first seven months of the year.

Figure 2: Unemployment rate easing after reaching a peak of 7.2% in Q1 2010



Source: Bloomberg

GDP growth seen marginally positive this year; small acceleration is expected in 2011

Looking ahead, we expect an anemic rebound in domestic economic activity in the coming quarters, which will be primarily driven by the services sector. Domestic demand growth is seen remaining moderate, with business investment likely to return to an expansionary territory towards the end of this year and to become a positive contribution to growth in 2011. The ongoing adjustment in inventories should continue providing support in the quarters ahead, albeit at a lower magnitude relative to H1 2010. Household consumption – the growth and contribution of which turned positive in Q2 - will probably improve further ahead and thus provide additional support to GDP growth in H2 2010 and throughout next year. On the flipside, the need for fiscal prudence ahead leaves little room for public spending to provide a significant boost over the next few years. Finally, net exports' contribution to GDP may worsen in the period ahead – following a negative input in Q2 – as private consumption improves further.

Risks to our forecasts for this year and the next lie in the face of a slower than expected recovery in trade-partner economies, which may weigh on exports and tourism. Note that the latter accounted for ca 10% of GDP in 2009. Moreover, increased taxation as part of fiscal austerity measures may weigh on investment and consumption. For the current year, we expect a rebound in real GDP growth to around +0.5% from -1.7%yoy in 2009. The trough of the economic downturn appears to have already been reached and a gradual improvement is likely in the quarters ahead. Our growth forecast for 2010 is broadly in line with that currently expected by the government, while for next year we expect an acceleration to 1.5%yoy, a rate slightly lower than that projected by the IMF (+1.8%yoy).

Fiscal consolidation remains a key policy challenge

As has been the case with most economies in the region, the global financial crisis brought about a significant deterioration in Cyprus's public finances. Following surpluses of 3.4%-of-GDP and 0.9%-of-GDP in 2007 and 2008 respectively, the budget swung into a deficit of 6.0%-of-GDP in 2009. As a result, the European Union launched in May 2010 its excessive deficit procedure (EDP) against Cyprus as the country breached last year the Treaty's 3%-of-GDP deficit threshold. Importantly, the recent worsening in the country's fiscal position has not been solely driven by cyclical factors and the economic stimulus measures employed to ease the impact of the crisis. It has also been a reflection of structural weaknesses, especially on the spending side, including high wage-related expenditure and, at times, largely untargeted transfers to broad social groups. This implies that, even though stimulus measures are gradually reversed and GDP growth returns to positive territory, additional fiscal tightening will likely be needed in order to eliminate the exessive deficit and brink the fiscal position to a more sustainable path.

The government has already employed a number of measures aiming to contain the deficit to levels around 6%-of-GDP this year, and to reduce it gradually below 3%-of-GDP by 2013, as promised in the country's latest stability program issued in March 2010. Among others, these measures include: a) a freeze in new hires and a downsizing of the overall public-sector labor force by 1,000 employees per year b) reductions in operating expenditure and c) a better prioritization of infrastructural projects.

The general government budget deficit is expected to reach levels around 6%-of-GDP in 2010, broadly in line with last year's outcome

In the first nine months of the year the government managed to reduce operational expenditure by 2.5%yoy but overall expenditure rose by 5%yoy. The Ministry of Finance noted that the increase was inflated by temporary factors including, among others, certain changes in the methodology used to calculate pension payments. On the other hand, revenues registered a 6.4%yoy rise year-to-September, bringing the overall budget deficit to ca €394mn or 8.7% lower comparing to the same period a year earlier. As a percentage of GDP the year-to-September central government budget deficit amounted to 2.25%, a tad below a shortfall of 2.55% recorded in the same period a year earlier. As portrayed by the aforementioned, the 2010 general government budget deficit is unlikely to improve significantly relative to last year.

2011 draft budget targets deficit of 5.4%-of-GDP, higher than that envisioned in the March 2010 stability program

For 2011, the government estimates that in the absence of fiscal tightening measures the budget deficit would rise further to 7.0%-of-GDP. However, by employing reductions in certain discretionary expenditure items, prioritizing development projects, strengthening social security policies and supporting the economic recovery, the 2011 budget deficit will be contained at 5.4%-of-GDP. The assumptions underlying the latter target appear to be broadly realistic, with economic growth seen accelerating to 1.5%yoy, annual inflation averaging around 3.0%yoy, budget revenues growing by 4.7%yoy and expenditures increasing by 1.1%yoy in 2011. Even so, the 5.4%-of-GDP deficit target envisioned in the (recently unveiled) 2011 draft budget remains in excess of the 4.5%-of-GDP shortfall envisaged in the March 2010 stability program. The gap corresponding to these two deficit figures is estimated to be ca €150mn.

In an effort to facilitate an elimination of the exessive deficit by 2013, the government tried to pass in parliament two bills in July. The proposals included: a) a 1ppt increase in the corporate tax rate to 11% and b) certain changes in real estate taxation. However, both bills failed, with lawmakers citing potential risks to the still nascent domestic economic recovery. Alternative plans have been submitted to parliament, but little progress appears to have been made so far. As recently as mid-October, the Finance Minister left the door open for a 1ppt increase to 16% in the main VAT rate as part of proposed measures to fill next year's €150mn budget hole. A levy on banks, a new 5% VAT rate on food and pharmaceuticals are among the measures under consideration.

High growth in public sector wage bill limits room for a more sustained fiscal consolidation

At present, the attainability of the stability program's deficit target of 4.5%-of-GDP next year remains doubtful, while no convincing measures have been introduced so far to help reduce the fiscal gap on a more sustainable basis over the coming years. Specifically, most of the new measures included in the 2011 budget draft are on the revenues side, while expenditure reductions target, primarily, operating costs and development-related spending, which may bear only a limited impact medium-term. Furthermore, the government's proposals currently under discussion do not contain any reforms aiming to address a ballooning public sector wage bill. The latter is among the budget's heaviest burdens, accounting for ca 30% of all public expenses. Public sector wage growth is based on backward indexation, which creates stickiness and ongoing upward pressures in real wages. In 2011 the government estimates the wage bill to rise by 5%yoy i.e., 2ppts above expected inflation. And this is the case if the planned reduction of 1,000 employees is achieved. Otherwise, the increase in the total wage bill next year is estimated to be 6.5%yoy. In view of the above considerations, amendments in the wage-setting mechanism and additional measures to downsize the public sector would have a more sustainable effect on fiscal consolidation and also improve the country's competitiveness and growth prospects longer-term. The problem of untargeted social transfers is another issue that needs to be addressed in a more lasting way.

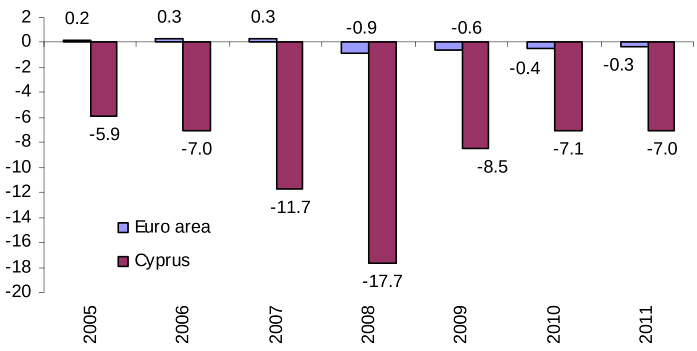
Fiscal prudence is key to the country's credit rating outlook and the maintenance of the debt ratio below the 60%-of-GDP threshold

With general elections looming in May 2011, a consensus between parliamentary parties on more aggressive fiscal consolidation is unlikely to prove an easy task. The recent deterioration in the country's fiscal position may also bear a number of additional repercussions. S&P placed Cyprus on review for possible downgrade in July, warning that its current credit rating could be cut in three to four months in the absence of improvement in public finances. On a more positive note, financial markets demonstrated their confidence on the Cypriot economy when in late October the government auctioned a 5-year bond. Demand was strong with the tender being 30% oversubscribed at €1.3bn. The Finance Minister said that with this auction the government covered the government's borrowing requirement for the next twelve months. The average accepted yield was at 3.84%, well below a yield of 4.7% for a 7-year bond auctioned six months earlier and while the corresponding yield spread to Bunds coming in a 172bps. International investors bought ca 80% of the issue, with the rest being absorbed by domestic accounts. The deterioration in government finances is, unsurprisingly, expected to bloat public debt in the years ahead. The government expects the public debt ratio to breach the Treaty's 60%-of-GDP threshold as soon as this year following a reading of 56.2%-of-GDP in 2009. A further rise ahead is likely if the country's fiscal position does not improve significantly in the years to come. Even so, the debt ratio is expected to remain ca 20ppts below the corresponding average euro zone figure, at least for this year.

Current account improves substantially as weak demand weighs on imports

Cyprus's current account deficit, one of the country's main vulnerabilities in recent years, remains in a downtrend after widening to a record of 17.7%-of-GDP in 2008. Weak domestic demand led to a sharp contraction in imports last year, which more than outweighed a concomitant decline in exports as a result of the recession in trading-partner economies. As a result, the current account shortfall narrowed to 8.5%-of-GDP in 2009. So far this year the current account data has been rather mixed, with a 50%yoy jump in the deficit in Q1 being offset by a 121%yoy fall in Q2. In fact, the current account swung into a surplus of €189mn in the second quarter of 2010, pushing the year-to-June deficit down by 83%yoy relative to the same period a year earlier. The primary driver of this improvement was the income account which swung into a surplus of €476mn in H1:2010 from a deficit of €434mn over the same period a year earlier. That said, the Q3 and Q4 data will be key in order to assert whether the substantial deficit decline witnessed in the second quarter of this year is sustainable and not the result of temporary factors.

Figure 4: Current account balance continues to improve, mainly thanks to lower imports



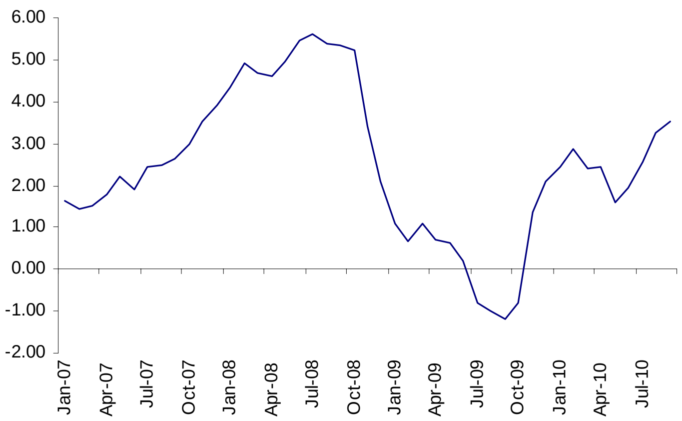
Source: European Commission spring forecasts 2010

For the year 2010 as a whole, we expect the current account shortfall to narrow to 4-5%-of-GDP, driven, primarily, by the second quarter's stellar performance. Looking further ahead, a tentative recovery in domestic demand may exert some widening pressures in the 2011 external shortfall, though the latter is unlikely to rise anywhere near to 2008 record levels. That said, a number of imbalances remain visible in the country's external position and could eventually lead to a more serious deterioration of the current account balance. Among them, faster growth in unit labor costs relative to main trading partners may have an eroding impact on competitiveness, while services exports continue providing a less-than-adequate coverage of the large trade balance. In order to contain the current account shortfall to sustainable levels in the medium-term, the aforementioned issues will need to be addressed in a more lasting way.

Inflation is edging higher

Consumer price inflation rose for the fourth consecutive month in September reaching 3.54%yoy, the highest rate since October 2008. As a result, year-to-September CPI advanced by 2.56%yoy, which compares with a full-year print of +0.3%yoy in 2009. The breakdown of the index over the first nine months of the year shows that the increase was broad-based and driven by base effects and improving domestic demand. Specifically, a 18.7%yoy jump in the prices of petroleum products added a 1.1ptps to headline inflation over that period. Services inflation rose by 1.5%yoy adding 0.7ppts to annual CPI, while domestic goods prices advanced 3.2%yoy with an input of 1ppt. The latter were primarily driven by a 24.3% jump in utilities costs. On the flipside, a 0.9%yoy drop in imported good prices exerted a negative contribution. Looking ahead, inflation is likely to remain at levels around 3.5%-4% for the remainder of this year. Oil and food prices are key for domestic inflation developments ahead due to their high weights in the CPI basket, estimated at around 20% and 10%, respectively. Potential tax rate increases currently under considered by the government, to the tune of 1ppt in the main VAT rate (currently at 15%) and/or the introduction of a new 5% VAT rate on food and pharmaceutical are likely to instigate some inflation pressures and push CPI above our 3.3% forecast in 2011.

Figure 5: Inflation rises on base effects, higher food and energy prices



Source: National Statistics

Worries of high private-sector indebtedness partially alleviated by household's net positive credit position, low loans-to-deposits ratio

Private sector indebtedness in Cyprus is currently among the highest in the European Union. Total outstanding MFI loans to domestic businesses and households stood at around 250%-of-GDP in August 2010. This vast ratio appears to be rather worrying at first glance. However, our contacts stressed that high household indebtedness *(~50% of all private sector loans)* is not a significant area of concern as domestic households' *net* financing position remains positive and there is a strong cultural component in their borrowing practices. It appears that domestic households prefer to borrow even when they hold significant positive liquidity balances, which they prefer to place in bank deposits. On the latter argument, note that the industry-wide loans-to-deposits ratio of domestic households stood at 86% in August. We were also told that around 80-85% of Cypriots own their own residence, while a high portion of household loans is backed by high quality collateral assets. Note also that household NPLs have stabilized to levels around 5-6% over the last few months and do not appear to pose any significant threat to the domestic banking system for the time being.

Domestic banking system strong enough to address potential challenges

Cyprus's total banking sector assets amounted to more than 1,041%-of-GDP as of May 2010, with local banks (banks whose home country is Cyprus) holding assets of 639%-of-GDP. The aforementioned figures signal an oversized sector compared to the economy, which requires strong vigilance. Nevertheless, it appears that the banking sector is relatively sound and well positioned to address potential challenges that may arise in the future. On the latter, note that Cyprus's financial system managed to weather well the global financial crisis. A significant cushion against the crisis was that domestic banks had minimal direct exposure to toxic assets. Furthermore, the banking sector remains well capitalized as suggested by its risk-weighted Capital Adequacy Ratio (CAR) which stood around 11.9% as of end-May 2010, ca 4ppts higher than the regulatory minimum. Furthermore NPLs remain at relatively low levels, while a minimum stock liquidity ratio of 70% on FX deposits (in liquid assets A-1/P-1 and above) is another area of strength. Finally, two Cypriot banks were subject to the EU's stress tests which they successfully passed.

Medium-term drivers of growth

From a medium-term perspective, prospects for the Cypriot economy remain favorable. The country's geographical location, which links it with both Europe and the Middle-East, provides significant potential for trade- and investment-related gains ahead. Meanwhile, the prospect of a reunification of the island has the capacity to bear substantial gains for domestic economic activity, as it would lead to a wide-scale reconstruction of the island, boosting investment, real estate activity and tourism. A waiver of the trade embargo with Turkey could also assist economic activity significantly. Last but not least, the country's tax-incentive status is likely to continue supporting investments. Note that even if the government proceeds with certain increases in tax rates, the latter are likely to stay among the lowest in the EU-27.

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