Research Report on Cyprus

20 November 2015

Author:

Gustavo Angel
Expert of Rating-Agentur Expert RA GmbH

For further information contact:

Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

Summary

Cyprus continues to demonstrate signs of economic recovery as authorities remain committed to implementing the structural reforms agreed with the EU and the IMF in mid-2013. Fiscal reforms were successful at reducing the budget deficit and reaching almost a balanced budget in 2014. The prospects are even more encouraging in the wake of resumption of GDP growth in 2015, first since 2011. Government debt has stabilized at about 100% of GDP, while short term liabilities have significantly decline reducing immediate risks.

Extremely high level of non-performing loans (NPLs) thinly covered by impairment reserves will continue to present key risks for the banking system and the country as a whole in the medium- to long-term. However there are encouraging signs such as resumption of the banking sector profitability and new insolvency and foreclosures laws.

Low exchange reserves and high dependence on capital and tourism flows from the crisis-hit Russia and Ukraine present additional risks.

Main Economic Indicators of Cyprus

Macro indicators	2012	2013	2014
Gross gov. debt, EUR bn	15	19	19
Nominal GDP, EUR bn	19	18	18
Real GDP growth, %	-2,4	-5,4	-2,3
Gross gov. debt/GDP, %	79,5	102,2	107,5
Deficit (surplus)/GDP, %	-5,8	-4,4	-0,2
Inflation rate, %	1,5	-1,3	-1,0
Current Account Balance/GDP, %	-	-	-4,5
External debt, USD bn	-	-	95,2

Development indicators	2014
Inequality adj. HDI	0,75
GDP per capita, USD th	30,9

Default indicator	16.11.2015
10Y Gov Bond Yield, %	3,9

Source: RAEX (Europe) calculations based on data from IMF, WB

Encouraging results of corrective measures. The Cypriot economy has shown signs of recovery since 2014 and prospects are encouraging. On May 2013, Cyprus agreed with the IMF and EU on EUR 1bn financial assistance under the so called Extended Fund Facility (EFF). Privatization of state-own enterprises (SOEs) in selected industries (telecom, electricity and ports) and fiscal reforms were at the core of conditions for Cyprus. These measures were intended to improve economic efficiency while encouraging foreign direct investments and reducing the public debt and the fiscal deficit.

Since the EFF was agreed, key macroeconomic variables of Cyprus improved strongly (see table 1). Real GDP growth rate increased by 3p.p. in 2014. The Agency expects it to become positive in 2015 and to remain so in the mid-term. As a result, unemployment rate stabilized at 16% in 2014 and is likely to start declining over the next years.

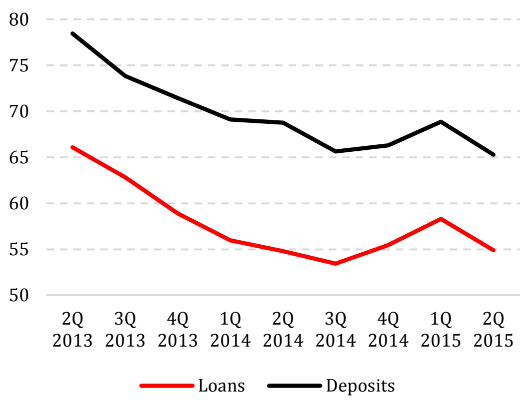
The country continues to experience deflation (at 1,8% year-on-year in October 2015) driven mainly by declining energy and tourism prices. However, the Agency forecasts ECB's QE programme will bring the inflation rate closer to the Euro area target (2%) through higher domestic

Table 1: Indicators of economic growth

	2013	2014	2015f	2016f	2017f
Real GDP growth rate	-5,4%	-2,3%	0,5%	1,4%	2,0%
Unemployment rate	16%	16%	16%	15%	14%
Inflation rate	-1,3%	-1,0%	-1,0%	0,9%	1,3%
Domestic demand growth rate	-9,9%	-1,3%	0,1%	1,1%	1,4%
BoP/GDP (%)	-24%	-7,4%	-6,5%	-16%	0,1%

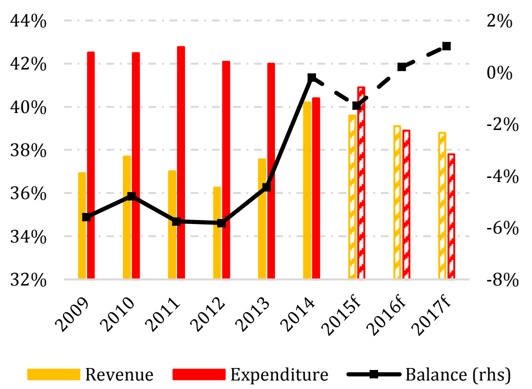
Source: RAEX (Europe) calculations based on data from IMF

Graph 1: Loans and deposits in Cypriot banks (EUR bn)



Source: RAEX (Europe) calculations based on data from the Central Bank of Cyprus

Graph 2: Fiscal position of the Cyprus government (% of GDP)



Source: RAEX (Europe) calculations based on data from the Central Bank of Cyprus

demand in the medium term. We also expect Cyprus external position to recover in 2017 driven by higher exports and stronger direct investments. Nonetheless, low exchange reserves and high dependence on capital and tourism flows from the crisis-hit Russia and Ukraine present additional risks.

Banks are profitable with downside risks. ROA of the Cypriot banking sector was positive 0,3% in 1H 2015 and 1,2x higher than the 1H 2014 figure. However extremely high NPLs, alongside low loss reserves present high downside risks on the banking system. NPLs increased to 45,4% at end-2014 from 4,5% in 2009 as a result of lax lending practices.

Average capital adequacy ratio more than doubled during that period, reaching 10,7% at end-2014. However, low coverage of NPLs by impairment provisions (43% of total NPL during 1H 2015) could deplete additional capital to cover further losses and harm profitability.

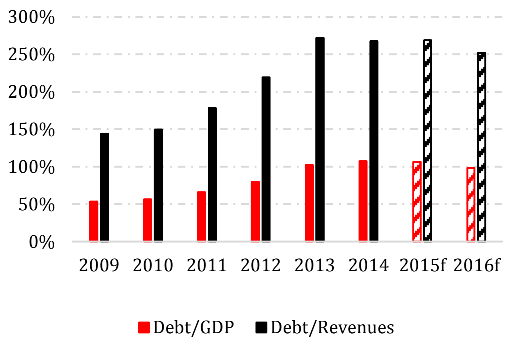
Furthermore, credit and deposit contraction also present strong risks to banks' profitability. Loans and deposits declined at a constant pace until 3Q 2014, when they stabilized at about EUR 65bn and EUR 55bn respectively (see graph 1). These trend responds to the loss of public confidence in the banking sector as well as deteriorating economic conditions in countries Cyprus has strong links with (Russia, Greece and Ukraine).

Despite the country's reducing dependence on Greece, the Agency expects that developments in Greece will continue to affect Cyprus through the confidence channel in the short- and med-run. If fully implemented, Russian government's "de-offshorization" policy is likely to harm Cyprus' financial sector in the long-run.

Reforms boosted fiscal results. In 2013 the Cypriot government introduced a number of fiscal reforms aimed at reducing the budget deficit, which was at 4,4% of GDP at the time. One of the measures considers the reform of the public administration. This consists of controlling the growth of public sector wages as well as increasing the efficiency of the public sector.

Additionally, authorities adopted a new government guarantee management framework aimed at improving the management of fiscal risks arising from guarantees (currently around 20% of GDP). Furthermore, in an attempt to improve fiscal results, the parliament reformed laws regulating the functioning, oversight and governance of SOEs in October 2015.

Graph 3: Cyprus gross government debt



Source: RAEX (Europe) calculations based on data from IMF

As a result of the aforementioned reforms, the fiscal deficit declined to 0,2% of GDP in 2014 (see graph 2). Despite 1H 2015 cumulative fiscal surplus reaching 0,3% of GDP, the full year fiscal balance will close at -1,3% of GDP. However, economic recovery will lead to a fiscal surplus at about 1% of GDP by end-2017.

Government debt remains high. Cypriot government debt indicators sharply increased during the period 2009-2013 (see graph 3). Economic and fiscal reforms introduced in mid-2013 alongside IMF-EU financial assistance contributed to the stabilization of debt. We expect debt indicators to improve in the mid-term driven by stronger GDP and budget revenues.

Short-term obligations declined to 7,1% of GDP and 17,8% of budget revenues in 2Q 2015 from 11,8% and 28% respectively at end-2014. This contributed to lower pressure on public finances and the Agency expects this trend to continue in the medium term.