INTERNATIONAL GROUP OF RATING AGENCIES

RAEX EXPERT RA RATING AGENTUR EUROPE

Moscow - Ekaterinburg - Almaty - Minsk - Frankfurt - Hong-Kong

Research Report on Cyprus

22nd of May, 2015

Author:

Gustavo Angel
Expert of Rating-Agentur Expert RA GmbH

For further information contact:

Rating-Agentur Expert RA GmbH
Office 601a, Mainzer Landstrasse 49,
60329 Frankfurt am Main, Germany
+49 (69) 3085-54-85
E-mail: info@raexpert.eu
www.raexpert.eu

Introduction

Cyprus is one of the European countries which suffered the consequences of the financial crisis the most. After the outbreak of the crisis in 2008, the country faced a number of issues in different sectors of the economy, especially the financial industry. Since the enforcement of the Economic Adjustment Programme in early 2013, the country has shown improvements in many variables which contribute to the creditworthiness of the country. Latest official data released, shows that key factors such as government debt, fiscal deficit and GDP growth performed remarkably during the last year. Additionally, the recent lifting of capital controls is expected to contribute significantly to the economic recovery of the country.

Main Economic Indicators of Cyprus

Macro indicators	2012	2013	2014
Gross pub. debt, bill EUR	15	19	19
Nominal GDP, bill EUR	19	18	18
Real GDP growth, %	-2,4	-5,4	-2,3
Gross gov. debt/GDP,%	79,5	102,2	107,1
Deficit (surplus)/GDP,%	-5,8	-4,3	-0,1
Inflation rate,%	1,5	-1,3	-1,0
Curr. Account balance/GDP,%	-6,3	-1,7	-1,9

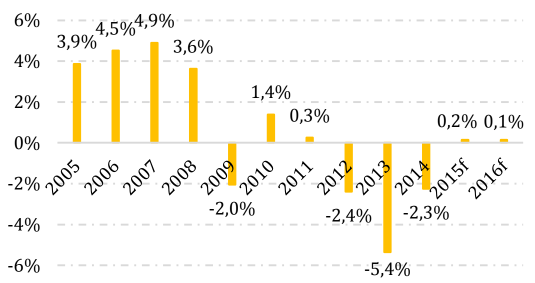
Development indicators	2014
Inequality adj. HDI	0,8
GDP per capita (Thou. of USD)	30,8

Sources: RAEX (Europe) calculations based on data from World Bank, IMF

Cyprus is showing signs of recovery despite persistent deflation rates. Inflation rate in Cyprus was negative during 2013 and 2014 with the end of period consumer price index declining by 1,3 p.p. and 1 p.p. respectively. According to the latest release of Eurostat, the annual rate of inflation for April 2015 decreased to -1,7% compared to -1,4% in March 2015. Even though prices showed a negative trend for more than 2 years now, Cyprus economy grew 1,6% in the first quarter of 2015, according to estimates from the statistical service of Cyprus. This growth was fuelled by stronger private demand, especially in the trade sector, hospitality industry and professional services. However, the output in manufacturing and construction has declined. The trend of GDP growth is expected to prevail in the years to come, showing a saddle point in 2013 (see graph 1). Currently, the country is going through a three-year economic adjustment programme as agreed with the EU and the IMF in exchange for a 10 billion EUR bailout deal which took place in early 2013.

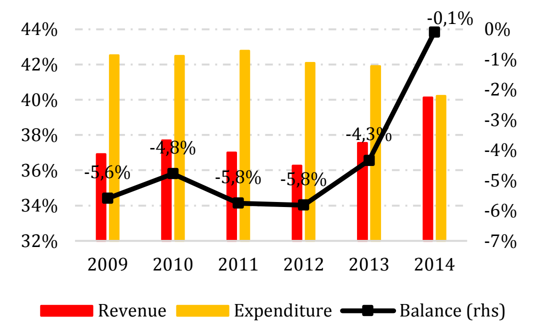
Cyprus fiscal position showed a significant improvement over the last year. After the outbreak of the 2008 financial crisis, the Cypriot fiscal balance deteriorated significantly as a result of growing government expenses and declining fiscal revenues (see graph 2). The highest deficit figures were registered in 2011 and 2012, accounting for 5,8% of GDP in both years. Since 2013 this trend has reverted, showing a noticeable

Graph 1: Cyprus GDP growth rate



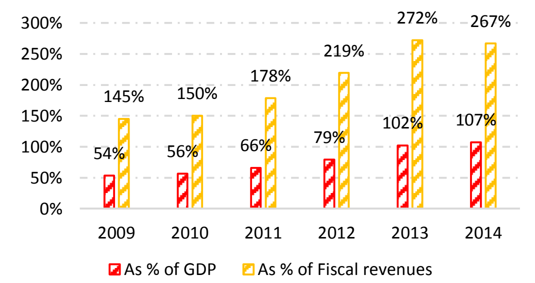
Source: RAEX (Europe) calculations based on data from IMF

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



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

Graph 3: Cyprus gross government debt



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

improvement of the fiscal balance. The slight deficit recorded by the end of 2014 (0,1% of GDP) was the lowest in the last six years.

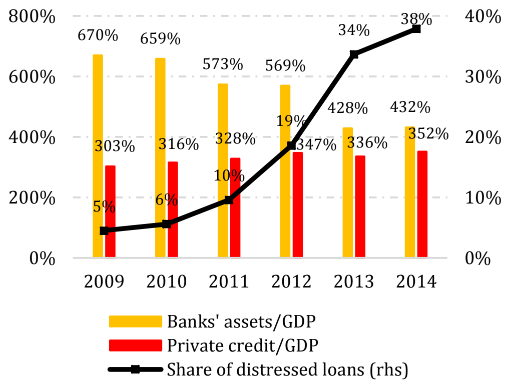
Gross government debt remains high with a upward trend. Fueled by tighter austerity measures and a recent reduction of the fiscal deficit, Cyprus gross government debt stabilized around €18 billion since 2013. While debt to GDP ratio was 107% by the end of 2014, its 2013-14 growth rate was significantly lower than that of previous years (see graph 3). Given recently announced encouraging prospects for the Cypriot economy, we expect this ratio to start showing a downward trend in the years to come. In contrast, debt to fiscal revenues ratio showed a downward shift in 2014, ending the year with a value of 267%.

Recently, domestic and external payment restrictions were lifted by the Cypriot government. Measures implemented by the Cypriot government by the end of 2011 to prevent a potential deposit run, and therefore preserve the stability of the financial system, were dismissed in April 2015. This measure was welcomed by the business sector of the country as it brings back normality to the banking system and helps attract foreign investments. Now when the external controls have been lifted, both businesses and individuals will be allowed to transfer money abroad without any restrictions. During the time restrictions were in place, there were cash withdrawal limits of €9 000 per month, the use of credit cards abroad was restricted to maximum of €5 000 per person per month and domestic wire-transfers were only allowed for individuals and legal entities up to €3 000 and €50 000 per month respectively.

The banking sector of Cyprus shows mixed results. As a result of large disposal of non-core bank assets and loan-book deleveraging, which followed the adjustment programme implemented by the Cypriot authorities on March 2013[1], the banking system of the country ended 2013 with a ratio of assets to GDP and volume of credit to GDP equal to 428% and 336% respectively. However, 2014 saw a reversion in the trend of these variables with an assets to GDP ratio of 432% and credit to GDP ratio of 352% by the end of the year (see graph 4). This reversal can be in part explained by the better conditions and prospects of the Cypriot economy. In contrast, the banking sector is still showing signs of weakness as the share of distressed loans to total loans climbed steadily since the outbreak of the financial crisis in 2008.

[1] On 25 March 2013, a €10 billion international bailout by the Eurogroup, European Commission (EC), European Central Bank (ECB) and International Monetary Fund (IMF) was announced, in return for Cyprus agreeing to close the country's second-largest bank (the Cyprus Popular Bank, also known as Laiki Bank), imposing a one-time bank deposit levy on all uninsured deposits there, and possibly around 40% of uninsured deposits in the Bank of Cyprus (the island's largest commercial bank), many held by wealthy citizens of other countries (many of them from Russia) who were using Cyprus as a «tax haven».

Graph 4: Cyprus banking sector position



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

Conclusion

Cyprus progress in addressing the crisis had a positive impact on the overall stance of the country. Since economic measures came into force in early 2013, the country has shown noticeable improvement of many macroeconomic indicators. Even though the banking sector still shows unclear prospects, recent lifting of capital controls combined with reduction of government debt and budget deficit fuelled the encouraging forecasts for the country.