Research Report on Cyprus

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Introduction

Cyprus is a small island country which is a member of the European Union and Euro Area since 2004. Despite the country shows sound figures of economic and social development, it was increasingly faced with serious challenges in terms of unsustainable external and internal macroeconomic imbalances since the outbreak of the crisis in 2008. While the debt load of the country soared in recent years reaching a value of 112% of GDP in 2013, a number of measures were put in place by the government in order to preserve financial stability, consolidate fiscal and debt position and solve economic imbalances in the country.

Cyprus fiscal position deteriorated significantly in the years after the 2008 financial crisis. Triggered by a significant increase of government expenses as well as a decline in revenues, fiscal budget showed negative figures in the years which followed the 2008 financial crisis (see graph 1). Even though current figure (-4,9% in 2013) remains at tolerable levels, it stands well behind pre-crisis values and is still far from the -2,4% target that the European commission planned for Cyprus in 2013.

While total government debt reached high levels in recent years, short-term debt poses no risk to the creditworthiness of Cyprus. The ratio of gross government debt to GDP more than doubled during the period 2008-2013, reaching a value of 112% by the end of 2013. The economic adjustment program outlined by the European Commission in the aftermath of the 2012 banking crisis included debt targets (86% and 110% of GDP for 2012 and 2013 respectively). As shown in graph 2, actual figures of gross government debt were pretty close to the targets defined by the European Union. Additionally, given that short-term debt stood at 17,4% of GDP and 41,9% of budget revenues in 2013, it poses no risk for the Cypriot economy in the short- and mid-run.

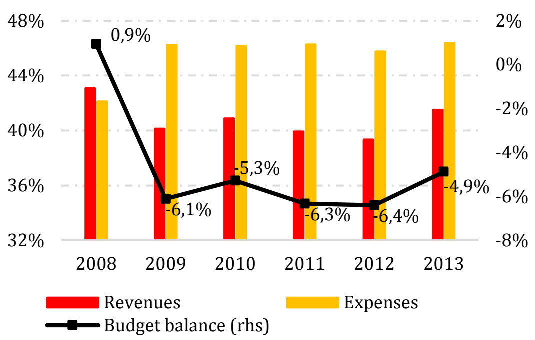
Main Economic Indicators of Cyprus

Macro indicators	2011	2012	2013
Gross pub. debt, bill EUR	12,8	15,4	18,4
Nominal GDP, bill EUR	17,9	17,7	16,5
Nominal GDP growth, %	2,7	-0,9	-6,9
Gross gov. debt/GDP,%	71,5	86,6	111,5
Deficit (surplus)/GDP,%	-6,3	-6,4	-4,9
Inflation rate,%	4,2	1,5	-1,3
Curr. Account balance/GDP,%	-3,4	-6,9	-1,9

Development indicators	2013
Inequality adj. HDI	0,75
GDP per capita (Thou. of USD)	28,8

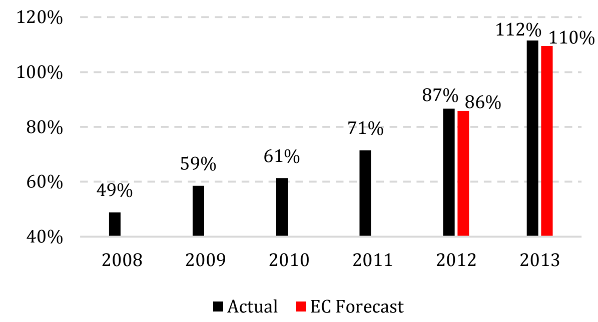
Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg

Graph 1: Fiscal position of the Cyprus Government (as % of GDP)



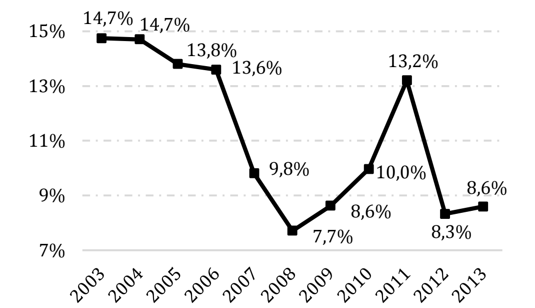
Source: RAEX (Europe) calculations based on data from IMF

Graph 2: Cyprus gross government debt (as % of GDP)



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

Graph 3: Gross National Savings Rate in Cyprus (as % of GDP)



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

Table 1: Capital and deposit restrictions in Cyprus

Cash	- Withdrawal limit: €9000 per month. - Export of bank notes limit: €2000 per journey.
Checks, credit, debit	- Cashing of checks prohibited. - Use of credit card abroad limited to €5000 per person per month.
Wire-transfers	- Business transfers: >€300 000 domestic: >20 000 cross-border (subject to approval). - Individuals may transfer up to € 3000 to another domestic bank. - Legal persons may transfer up to €50 000 to another domestic bank.
Other restrictions	- Prohibition to open new bank accounts. - Extension of term deposit.

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

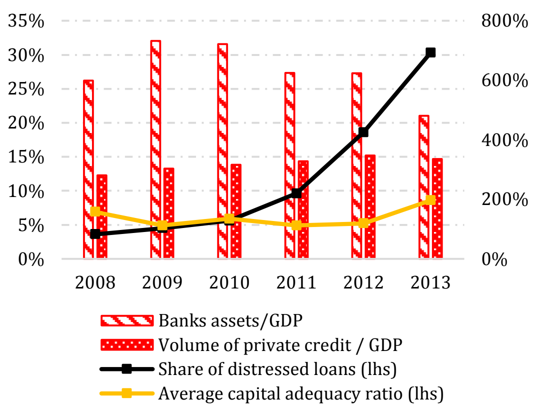
Over the past decade, gross national savings rate fluctuated significantly in Cyprus. During the pre-crisis years, mainly fueled by easy credit and a housing market boom, gross national savings rate almost halved from 14,7% in 2003 to 7,7% in 2008 (see graph 3). In the years which followed the financial crisis (2009-2011) Cyprus' household savings rate recovered as a result of a noticeable decline of credit and the burst of the housing market bubble. After the crisis that Cyprus experienced in 2012[1] the savings rate returned to lower figures and reached a value of 8,6% by 2013. With such low and fluctuating savings rate, investment potential of the country remains uncertain.

Domestic and external payment restrictions are still in place in Cyprus in order to preserve financial stability of the country. By the end of 2011, Cypriot Banks holdings of Greek loans and Greek government bonds accounted for 130% and 40% of Cyprus GDP respectively. The intensification of the Greek crisis generated an erosion of confidence in the Cypriot banking system and the overall creditworthiness of the country, which ultimately triggered a mass deposit outflows from local banks. In order to protect the system from a potential deposit run, government authorities decided to implement domestic and external payment restrictions which still are in place (see table 1).

While the Cypriot banking system went through a restructuring and recapitalization process, it still shows signs of weakness. As a result of large disposal of non-core bank assets and loan-book deleveraging which followed the measures implemented by the Cypriot authorities on March 2013[2], Banks' assets declined to 480% of GDP (from 733% in 2009)

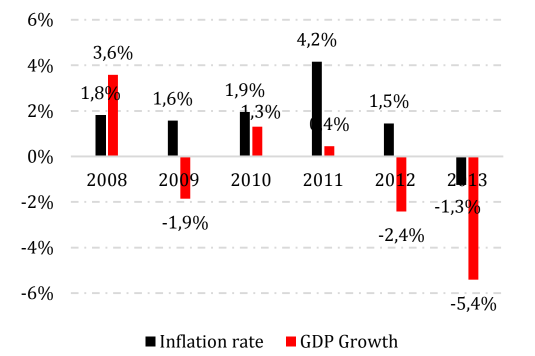
[1] The 2012–2013 Cypriot financial crisis involved the exposure of Cypriot banks to overleveraged local property companies, the Greek government-debt crisis, the downgrading of the Cypriot government's bond credit rating to junk status by international credit rating agencies, the consequential inability to refund its state expenses from the international markets and the reluctance of the government to restructure the troubled Cypriot financial sector.
[2] 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

Graph 4: Cypriot banking system position



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

Graph 5: Inflation rate and GDP growth in Cyprus



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

and volume of private credit dropped slightly to 336% of GDP in 2013 from 347% one year before (see graph 4). Even though the share of distressed loans remained almost unchanged until 2010, this figure soared significantly during the aftermath of the 2012-2013 banking crisis, reaching a value of 30% by 2013. Despite that situation, average capital adequacy ratio remained almost flat until 2012 before increasing to 9% one year after.

Current deflation rate may have negative effects on the economic position of the country. Since the outbreak of the crisis in 2008, Cyprus showed positive inflation rates which were followed by fluctuating values of GDP growth rates (see graph 5). However, latest deflation figure reported in 2013 (-1,3%) may delay consumption and investment and further harm GDP growth in the mid-run.

Conclusion

Even though Cypriot authorities put in place a number of adjustments and restrictions to improve the current economic situation, the government is still having a hard time complying with the targets defined in fiscal terms. Additionally, despite short-term debt is still at tolerable levels, gross government debt currently shows significantly high figures. Current situation observed in Cyprus' Banks seems stable but the sector still shows signs of fragility, mainly evidenced by high levels of distressed loans and low values of capital adequacy ratio.

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»