Euler Hermes Economic Research

Country Risk Analysis

Cyprus

Dire straits

General Information

GDP	USD24,7bn (World ranking 95, World Bank 2011)
Population	1.12 million (World ranking 157, World Bank 2011)
Form of state	Republic
Head of government	Nicos ANASTASIADIS
Next elections	2016, legislative

Strengths

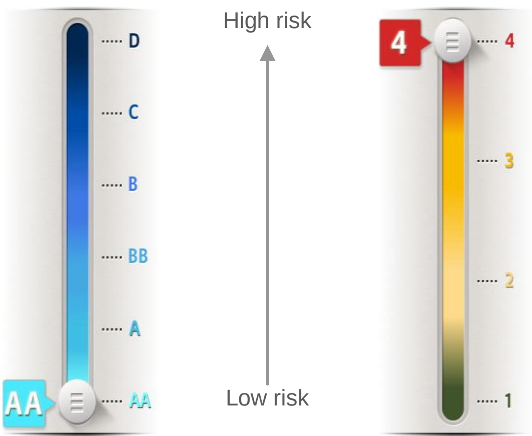
- EU membership
- Inflation is moderate
- Strong business environment

Weaknesses

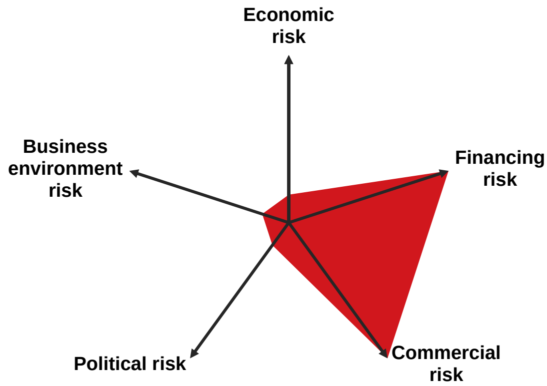
- Deep crisis of the outsized banking sector that has been highly exposed to Greek debt and will need substantial downsizing
- Economic model based on offshore banking unlikely to sustain
- Profound recession of uncertain duration
- Sovereign debt crisis: sharply deteriorating public finances, despite fiscal austerity measures, will cut off Cyprus from international capital markets for a long time
- Very high gross external debt

Country Rating

AA4



Risk Dimensions



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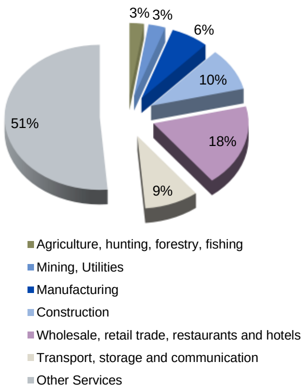
Economic Structure

GDP breakdown (% of total, 2010)



Sources: UNCTAD, Euler Hermes

Trade structure (% of total, 2010)

By destination/origin

Exports		Rank		Imports
Greece	22%	1	12%	Greece
Germany	8%	2	9%	Russian Federation
Korea, Republic of	7%	3	7%	China
United Kingdom	6%	4	7%	United Kingdom
Israel	6%	5	7%	Germany

By product

Exports		Rank		Imports
Petroleum, petroleum products and related materials	26%	1	25%	Petroleum, petroleum products and related materials
Medicinal and pharmaceutical products	10%	2	7%	Road vehicles
Other transport equipment	6%	3	4%	Electrical machinery, apparatus and appliances, n.e.s.
Electrical machinery, apparatus and appliances, n.e.s.	6%	4	4%	Articles of apparel & clothing accessories

Economic Forecasts

	Average 2000-08	2009	2010	2011	2012	2013f	2014f
GDP growth (% change)	3.7	-1.9	1.3	0.5	-2.4	-8.5	-4.5
Inflation (%, end-year)	2.6	1.6	1.9	4.2	1.1	1.3	1.2
Fiscal balance (% of GDP)	-2.1	-6.1	-5.3	-6.3	-6.3	-6.5	-8.4
Public debt (% of GDP)	63.9	58.5	61.3	71.1	85.8	109.5	124.0
Current account (% of GDP)	-6.4	-8.1	-8.1	-4.7	-4.8	-1.9	-0.6
External debt (% of GDP)	185.5	541.1	491.9	465.6	508.4	484.8	500.9

Sources: IHS Global Insight, national sources, European Commission, Euler Hermes

Economic Growth

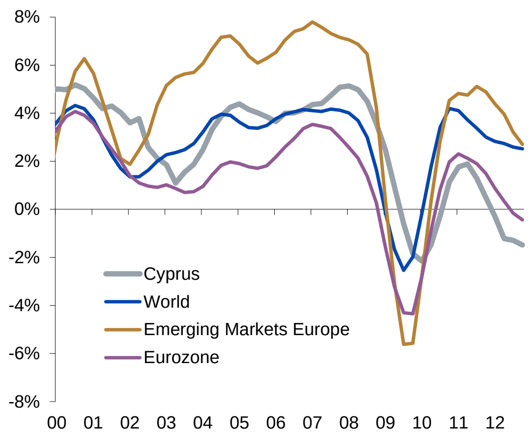
The economy contracted in 2012 ...

The economy has been in recession since mid-2011. In 2012, real GDP contracted by -2.4%, driven by a sharp decline in domestic demand which was affected by tighter credit conditions, fiscal austerity, rising unemployment and very weak consumer confidence. Private consumption fell by -3%, government consumption by -1.7% and fixed investment by -23%. Net exports made a positive contribution to 2012 GDP as exports expanded by +2.3% while imports decreased by -7.2%.

… and the recession will deepen sharply in 2013-2014

Economic activity deteriorated further in Q1 2013, with real GDP falling by -4.3% y/y and -1.3% in q/q seasonally-adjusted terms, marking the seventh consecutive quarter of contraction. The impact of the bail-out package agreed with the Troika (European Commission, ECB, IMF) in March 2013 and the attached adjustment programme—including the immediate reduction in the size of the banking sector which affects credit growth, more fiscal austerity, the loss of wealth stemming from the depositors' bail-in, the temporary capital controls and generally high degree of uncertainty—will deepen the recession considerably in the next two years. EH expects full year real GDP to contract by about -8.5% in 2013 and -4.5% in 2014.

GDP growth (% y/y, 4 qtrs cumulated)



Sources: IHS Global Insight, national sources, Euler Hermes

Economic Policies

Inflation is moderate

Consumer prices have been largely under control for over more than a decade. In the wake of declining domestic demand, headline inflation fell to 1.1% at end-2012 and shifted to deflation of 0.3% in April 2013. The deflationary trend is likely to continue for some months before swinging back to modest annual inflation of around 1%.

Public finances will remain a serious cause of concern for some time ...

Enormous fiscal consolidation efforts in 2005-2007 enabled Cyprus to adopt the EUR in 2008. But soon thereafter, in the wake of the 2008-2009 global economic crisis and the resulting domestic recession, public finances deteriorated again sharply. Despite sizeable consolidation efforts, the fiscal deficit came in at 6.3% in both 2011 and 2012, as tax revenues declined as a result of the renewed recession since mid-2011. Total public debt has risen sharply from 49% of GDP in 2008 to 86% in 2012. Against the background of the growing fiscal pressures, including the looming need to bail out major banks, international credit rating agencies have continuously downgraded Cyprus's sovereign risk rating several times over the past three years and since about mid-2011, the country has lost access to affordable financing in international capital markets. Although the government obtained a EUR2.5bn loan from Russia to meet its financing needs in 2012, it eventually requested for an international bail-out in June 2012. However, bail-out negotiations were delayed for a long time under then-president Christofias from the left-of-centre AKEL party, who was reluctant to accept more austerity.

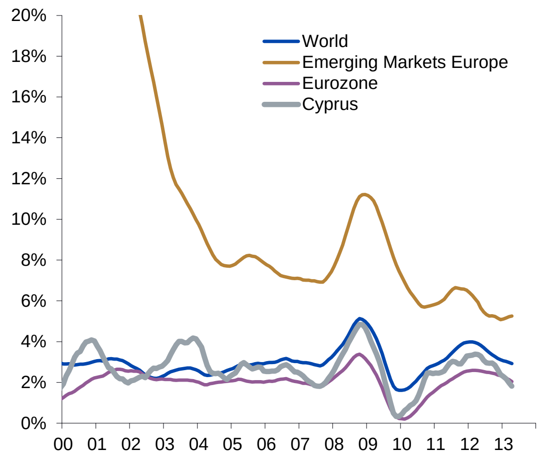
... despite the bail-out package

Bail-out negotiations gained new momentum after Nicos Anastasiadis from the centre-right DISY party won the presidential election in February 2013. However, the outcome surprised markets and many analysts.

After an extremely tense period, during which banks in Cyprus were closed for almost two weeks, a bail-out package with the Troika was agreed at the end of March. Crucially, Laiki Bank (the country's second largest bank) will be split into a 'bad' and a 'good' bank. In the former, 40% of deposits above EUR100,000 will be converted to equity. The latter will be absorbed by Bank of Cyprus (BoC, the largest bank) in which deposits above EUR100,000 will also be subject to a debt swap (sufficient to reach a capital ratio of 9%, but at least 37.5%). The ECB will continue to provide liquidity support. Temporary controls have been placed on bank withdrawals. Another requirement is a reduction in the size of the banking sector to the eurozone average. Fiscal measures include a higher corporate tax rate and a privatisation programme. The Eurozone and IMF will provide up to EUR10bn to cover the government's financing needs while maintaining debt sustainability.

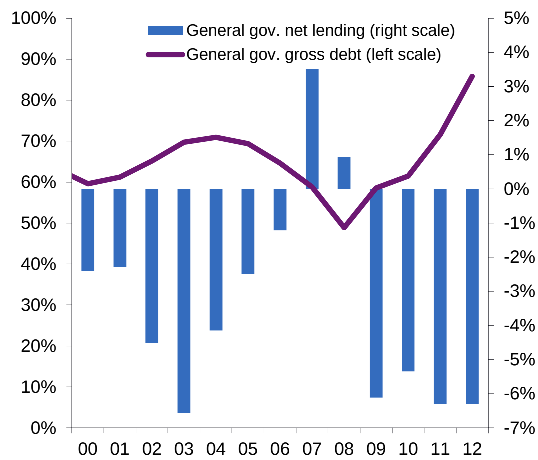
Full implementation of the adjustment programme will be challenging and will test government resolve, with debt sustainability finely balanced for some time. It cannot be ruled out entirely that the agreed bail-out package turns out to be just a temporary fix with more assistance required later, including a restructuring of the heavy public debt.

Inflation rate (12-month moving average, %)



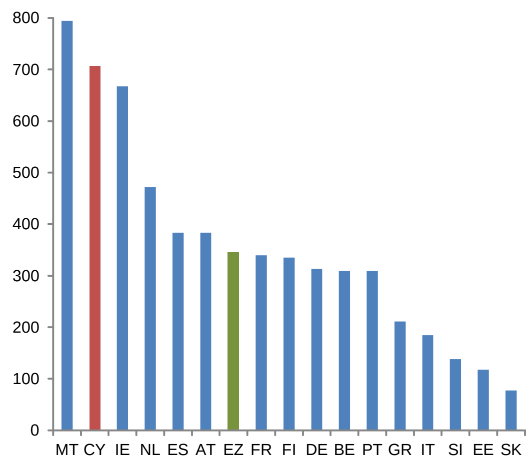
Sources: IHS Global Insight, national sources, Euler Hermes

Fiscal balance and public debt (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

Total banking sector assets (% of GDP)



Sources: ECB, Eurostat, Euler Hermes

External Sector

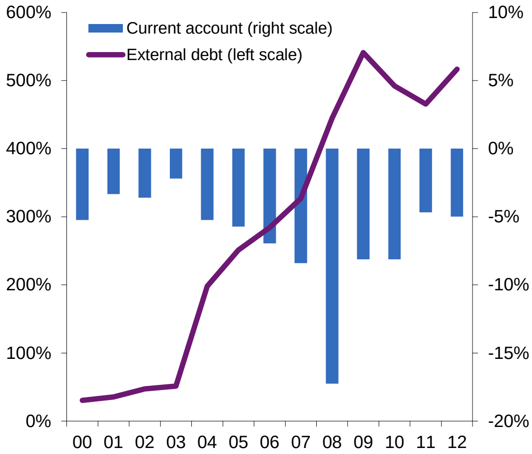
Current account likely to narrow in 2013

The current account deficit has declined from more than 8% of annual GDP in 2007-2010 to a still relatively high share of 4.8% in 2011-2012. However, we expect it to narrow to a more sustainable ratio of less than 2% of GDP in the next two years as imports will shrink substantially as a result of the sharply deepening recession.

External debt will remain very high

Gross external debt has increased rapidly in recent years and stood at an estimated 508% of GDP at end-2012. Most of this was private-sector bank debt and includes non-resident deposits in the banking sector. Although the reduction in the size of the banking sector (part of the bail-out programme) will reduce external debt of banks to some extent, gross external debt will remain very high.

Current account and external debt (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

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