Euler Hermes Economic Research

Country Report

Cyprus

Finally seeing the light at the end of the tunnel

General Information

GDP	USD23.226bn (World ranking 107, World Bank 2014)
Population	1.15mn (World ranking 158, World Bank 2014)
Form of state	Republic
Head of government	Nicos ANASTASIADES
Next elections	May 2016, legislative

Strengths

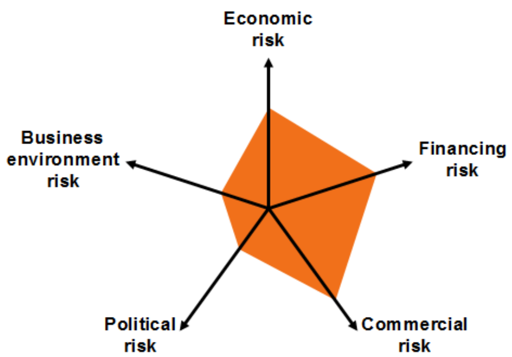
- Strong and stable business environment
- Attractive fiscal system for corporates (12.5% corporate tax rate, the lowest in the EU along with Ireland)
- Potentially large deposits of natural resources
- Highly skilled workforce

Weaknesses

- Overreliance in the services sector, especially financial sector (i.e. 80% of GDP mostly rely on tourism, financial services and real estate)
- Very high gross external debt due to still significant non-resident bank deposits
- High public debt
- High level of "shadow economy" (26% of GDP in 2012)
- Weak asset quality in the banking sector

Country Rating

B3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
South Korea	25%	1	14%	Russia
Greece	10%	2	11%	Greece
Israel	9%	3	8%	Germany
Egypt	6%	4	8%	Israel
United Kingdom	5%	5	8%	Turkey

By product (% of total)

Exports		Rank		Imports
Refined Petroleum Products	33%	1	25%	Refined Petroleum Products
Pharmaceuticals	8%	2	12%	Ships
Natural Gas	4%	3	9%	Toiletries
Basic Organic Chemicals	4%	4	5%	Telecommunications Equipment
Telecommunications Equipment	4%	5	3%	Non Ferrous Metals

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Economic Overview

Resilience to the Greek and Russian crises and domestic economic recovery managed to pull the country out of recession in 2015

2015 has been marked by a surprising return to growth for Cyprus. The country displayed positive growth in the last three quarters on the back of resilient private consumption and strong tourism activity. Indeed, despite weak wage growth, the labour market recovery (-1.1pt in the unemployment rate since Jan 2015 to 15.1%), the lower oil prices and negative inflation supported private consumption (+1% in H1 2015 compared to the same period in 2014). Retail sales confirm the resilience of private consumption in Q3 2015 (+4% y/y). Economic activity was strongly supported by tourist entries. In 2014, tourism contribution to GDP reached 21.3% and is expected to increase to 22.4% by the end of this year. Tourist entries were on the rise for the last three quarters compared to the same period in 2014.

On the supply side, both manufacturing and services (hotels and restaurants, transport, financial services) show signs of improvement. The index of industrial production was on a constant rise and grew by +4% q/q in Q3 2015. All in all, GDP is expected to expand by +1.5% in 2015. The recovery should continue in the coming years with a +2.0% GDP growth in 2016 and +2.3% in 2017.

A lift off capital controls in April 2015 after being introduced two years before

Cyprus' unexpectedly good growth figures in the first half of 2015, the return in confidence and significant improvements in banks' solvability determined the Cypriot government to lift the two-year lasting capital controls in April 2015. Indeed, financial conditions have gradually improved although there are a number of still unresolved issues. Despite better liquidity and solvency in the financial sector, the banking system is still plagued by the high number of non-performing loans (NPLs). In September 2015, the ratio of NPLs in the banking system stabilized at 47.8% and the total nonperforming exposure reached EUR27.3bn (with 57% for companies, the highest among EU countries). If recent indicators tend to indicate a pickup in debt restructuring (51.1% of total loans), NPLs remain the biggest challenge for the Cypriot economy and the fragile real-estate market will not support a high volume of foreclosed asset sales.

A succesful exit from the EU/IMF programme is expected by mid-2016

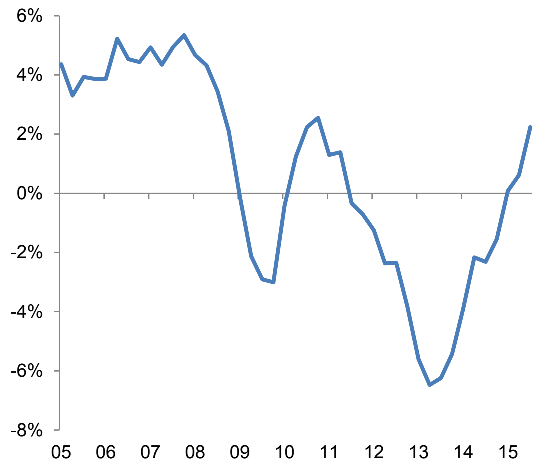
Since the recession of 2013, the Cypriot government is undergoing fiscal consolidation and debt restructuring. The country has passed all of the eight EU/IMF reviews with substantial positive margins (consistently exceeding the targets) and should be able to complete the EU programme in March 2016 and the IMF programme in May 2016 as scheduled.

Figure 1 - Key economic forecasts

	2014	2015f	2016f	2017f
GDP growth (% change)	-2.5	1.5	2.0	2.3
Inflation (%, average)	-1.0	-2.0	0.9	1.1
Fiscal balance (% of GDP)	-0.2	-1.3	0.1	0.9
Public debt (% of GDP)	108.2	106.4	98.4	93.2
Current account (% of GDP)	-4.5	-4.2	-3.8	-3.6

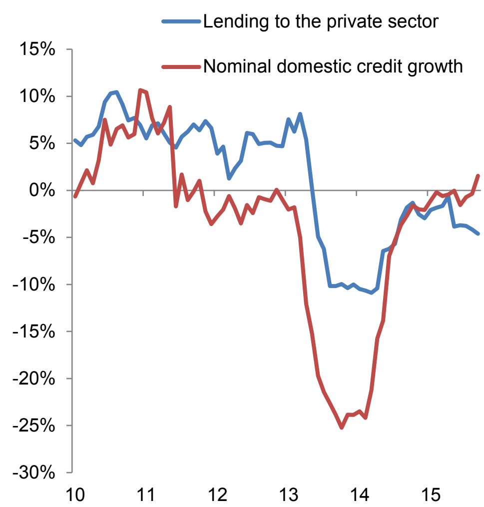
Sources: National sources, IHS, Euler Hermes

Figure 2 - GDP growth (y/y, %)



Sources: National sources, IHS, Euler Hermes

Figure 3 - Credit growth (y/y, %)



Sources: National sources, IHS, Euler Hermes

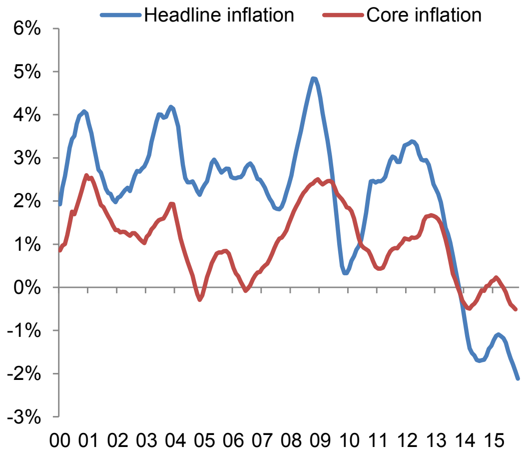
The Cypriot government has launched a set of structural reforms to support the State deleveraging process, going from a reform of the pension system to tax increases. The debt-to-GDP ratio peaked at 108% in 2014 and the primary fiscal balance, expected at +2.5% next year, coupled with positive nominal GDP growth, will allow a decrease to 98.4% in 2016 and 93.2% in 2017.

These positive results helped the government regain confidence in the bond market and start build cash buffers through market financing since last year that are estimated to allow repayments of all dues in 2016. The cost of financing has been significantly reduced. As such, in October a 10-year bond was successfully issued at the lowest rate for this maturity, 4.25%.

Downside risks steem from persistent negative inflation

Inflation has slowed down continuously since 2012 and fell in negative territory since end-2013. This year, low commodity prices, the base effects linked to the previous VAT rises and a still weak domestic economy result in inflation bottoming at -2.1% y/y in November. It should go back on a positive trend starting 2016 (see Figure 1).

Figure 4 - Inflation (y/y, %)



Sources: National sources, IHS, Euler Hermes

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