

COUNTRY REVIEW

Cyprus



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EULER HERMES COUNTRY RISK GRADE: AA

EULER HERMES COUNTRY RISK LEVEL: SENSITIVE

Country Risk Grades are on a scale of AA, A, BB, B, C, D

Country Risk Levels are on a scale of LOW, MEDIUM, SENSITIVE, HIGH

Strengths

- EU membership
- Euro zone membership provides for low transfer risk
- Strong business environment overall

Weaknesses

- Unresolved problem of partition of the island
- Dependence on tourism and EU business cycle creates vulnerability to external economic developments
- Sharply deteriorated fiscal position
- Large current account deficits
- Outsized banking sector that is highly exposed to Greek debt

KEY RISKS

- **Contagion from Greece owing to Cypriot banking sector's high exposure to Greek debt**
- **Bank failures**
- **Sovereign debt crisis if government has to bail out banks**

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Nicosia
Population:	0.88 mn (2010)
GDP:	USD 23153 mn (2010)
Currency:	EUR (since 1 January 2008)
Form of state:	Republic
Head of government:	President Demetris Christofias (since February 2008)
Next elections:	Presidential: February 2013 / Legislative: May 2016

Major Industries (% of GDP at market prices, 2008)	Global Assumptions	2010	2011
Services	79.0%	Real GDP grth (% yr/yr)	3.3
Industry	19.0%	Inflation (% av) *	1.2
Agriculture	2.0%	Dated Brent (USD/b)	80
		* Major economies	115

Main Exports (% of total, 2010)	Main Imports (% of total, 2010)
Re-exports	50.3%
Manufacturing products	31.3%
Agricultural products	15.7%
Mineral products	2.5%
Consumer goods	30.3%
Intermediate goods	27.2%
Fuels and lubricants	18.8%
Transport equipment	12.9%
Lead Export Markets (% of total exports, 2010)	Lead Import Markets (% of total imports, 2010)
Greece	24.1%
Germany	10.6%
UK	8.6%
Italy	2.6%
Russia	2.0%
Greece	19.1%
Italy	9.1%
Germany	8.9%
UK	8.3%
Israel	8.1%

Basic indicators

Selected economic indicators	2008	2009	2010	2011f	2012f
Nominal GDP (USD mn)	25,425	23,636	23,154	25,266	25,221
Population (mn)	0.862	0.871	0.880	0.889	0.897
GDP per capita (USD)	29,495	27,136	26,311	28,421	28,117
Real GDP growth (% yr/yr)	3.6	-1.7	1.0	0.0	0.7
Inflation (HICP%, eop)	1.8	1.6	1.9	3.9	2.6
Fiscal balance (ESA95; % of GDP)	0.9	-6.0	-5.3	-6.0	-5.5
Public debt / GDP (ESA95; %)	48.3	58.0	60.8	64.0	66.0
Current account balance (% of GDP)	-16.9	-7.4	-7.8	-8.0	-8.4
Gross external debt / GDP (%)	398.2	482.6	448.6	450.0	450.0
Net external debt / GDP (%)	4.0	9.0	10.0	12.0	12.0
Debt-service ratio (%)	20.2	9.8	8.2	8.4	18.8
Exchange rate assumption, USD:EUR (av)	1.47	1.39	1.33	1.40	1.35
f: CRU central forecast					

Sources: National sources, IMF, ECB, Eurostat, EC, IHS Global Insight, Euler Hermes Economic Studies

Political Stability

The island has been divided since 1974, when Turkish troops invaded the northern part in response to a Greek-sponsored coup d'état aimed at uniting the island with Greece. In 1983, the Turkish-held area declared itself the "Turkish Republic of Northern Cyprus" (TRNC), but is recognised only by Turkey. The government of "Greek Cyprus" is internationally recognised and represents the island in international organisations. This constellation has caused ongoing political tensions, with some potential for civil and/or military unrest and political instability, although instances of violence have been rare. Reunification negotiations have seen several ups and downs over the past decade, but the probability of a settlement in the next few years appears small.

(The Greek sector of) Cyprus has a strong presidential system of government in which the president appoints an 11-person cabinet of ministers. Demetris Christofias, leader of the nominally communist Progressive Party of Working People (AKEL), won the presidential election in February 2008 and replaced Tassos Papadopoulos of the Democratic Party (DIKO). In terms of economic policies, there was little change as the three-party coalition government of AKEL, DIKO and the Movement of Social Democrats (EDEK) that came to power in May 2006 remained in place under the new head. As EDEK left the coalition in February 2010, AKEL and DIKO still had a tiny parliamentary majority. The parliamentary election in May 2011 changed the picture. The main opposition right-of-centre Democratic Rally party (DISY) won, gaining 34.3% of the vote and 20 out of 56 seats, while the ruling coalition of AKEL (19 seats) and DIKO (9 seats) lost its absolute majority in parliament. The coalition tumbled further following an accidental, but serious, munitions explosion at a naval base on 11 July 2011. The blast destroyed a nearby power plant, the country's largest which accounted for around half of the islands power-generating capacity, sparking an energy crisis (rolling power blackouts) and political disarray (mutual accusations). In early August 2011, the coalition eventually collapsed as DIKO withdrew after earlier multi-party talks on fiscal austerity measures had failed.

Under the presidential system, the collapse of the government does not formally endanger President Christofias's position and the next presidential election is not due until 2013. Christofias appointed a new cabinet on 5 August, but its clear minority status will make it difficult to implement any controversial reforms. The most urgent challenge is a fiscal austerity package that Cyprus needs to introduce. For now, the new AKEL government swiftly agreed a range of controversial public-sector reforms with the powerful unions and was eventually able to win parliamentary backing for most of the measures, though a decision on a proposed VAT increase from 15% to 17% has been postponed. Negotiations with labour unions over amending the problematic pension structure and the budget for 2012 are further challenges.

Economic Stability

The Greek sector of Cyprus has shown strong signs of convergence towards economic levels in the old EU-15. With GNI per capita estimated at around USD30,000 in 2010, it is classified as a high-income economy by the World Bank, with generally high living standards. However, **a number of structural weaknesses pose risks to long-term stable growth**. Firstly, services account for almost 80% of GDP and around 85% of export earnings, largely originating from the tourism industry, making the business cycle highly susceptible to external shocks. This is reflected in erratic growth rates since the 1990s, resulting mainly from political instability on the island and cyclical fluctuations in the EU, the country's leading trade partner which accounts for more than 50% of exports. Secondly, a 50% share of re-exports of total merchandise exports adds to external vulnerabilities. Thirdly, Cyprus has an outsized banking sector that is at risk of being destabilised by events in Greece owing to its significant exposure to that country. A potential government bail-out of Cypriot banks would sharply deteriorate the country's fiscal position and could drag down the whole economy, similar to events in Iceland in 2008 and Ireland in 2010 (for details on the banking sector see below). Fourthly, another structural weakness has been disclosed by the destruction of the country's largest power plant in July 2011 as the subsequent rolling power blackouts have hit prospects for economic growth and fiscal consolidation (reconstruction will increase public spending).

After annual average growth of 4.2% in 2004-2008, the economy contracted by 1.7% in 2009 in the wake of the global economic crisis and returned to modest growth of 1% in 2010. In H1 2011, real GDP grew by 1.6% yr/yr, partly owing to base effects (negative growth a year earlier). In qtr/qtr, seasonally-adjusted terms, GDP was flat in Q1 and increased by 0.4% in Q2 2011. Growth in H1 was driven by the tourism, trade and banking sectors which, however, are likely to moderate from H2 as the global economy is slowing. Manufacturing and construction contracted in H1. Industrial output declined by 2.9% yr/yr in January-May 2011. The electrical power industry grew by 2.3% during the first five months, but should have been in decline since July. Domestic demand was already weak before the destruction of the power plant and is likely to weaken further owing to energy blackouts in

the near term, fiscal austerity, credit tightening and a bursting real estate bubble. Overall, **we forecast GDP growth to be flat in 2011**—in line with the latest government forecast—**and modest at 0.7% in 2012**. Downside risks include a potential fiscal bailout by the EU—which cannot be ruled out entirely—that would most likely require more austerity measures and thus reduce growth further.

Since Cyprus' accession to the euro zone in 2008, **monetary policy** is conducted by the European Central Bank (ECB). Inflation (EU harmonised measure) accelerated from an average 2.6% in 2010 to 4.5% yr/yr in June 2011 before falling to 3.5% yr/yr in July. We expect average inflation of about 3.3% this year and 2.8% in 2012. The real effective exchange rate does not appear to be significantly overvalued. Membership of the euro zone provides for low transfer and convertibility risk as long as the euro zone remains intact.

The fiscal position has become a serious source of concern. Substantial fiscal consolidation in 2004-2008 had shifted the fiscal account (ESA 95 standard) into surpluses in 2007 (3.4% of GDP) and 2008 (0.9%) and sharply reduced public debt to 48% of GDP in 2008 which enabled euro adoption in the first place. But in the wake of the global economic crisis in 2008-2009 and the resulting domestic recession, the fiscal account swung back to large deficits of 6% of GDP in 2009 and 5.3% in 2010 while public debt rose back to 61% of GDP in 2010. The 2009 deficit triggered the application of the Excessive-Deficit Procedure by the European Commission, which mandates sanctions should the deficit not be brought below the Maastricht limit of 3% of GDP by 2012. Although the Commission suspended the Procedure in January 2011—thus acknowledging that the government was on track to meet the target—the fiscal deficit actually swelled again to an estimated 7% of GDP in H1 2011, suggesting that more austerity may have been needed even before the serious explosion in July and the subsequent electricity supply disruption.

The damage by the blast has been a further setback to fiscal consolidation, as the replacement and reconstruction costs are estimated at anywhere between EUR0.8bn and EUR4bn (3-15% of GDP) while the power disruptions affect GDP growth. The recently announced public-sector reforms of the new cabinet are intended to bring down the fiscal deficit to 5.5% of GDP (revised upwards from an earlier 4%) this year and to under 3% in 2012 but there are considerable doubts that these targets will be achieved. Moreover, there is a risk that public debt servicing will be disrupted in the following months, as the Cypriot central bank has also highlighted.

International credit rating agencies have downgraded Cyprus's sovereign risk rating several times over the past ten months, citing heavy public debt-servicing due in the next 12 months or so, concerns about the implementation of a fiscal austerity programme and the banking sector's exposure to Greek sovereign and private sector debt. However, they still have the country at investment grade, albeit with negative outlook. According to a statement by Fitch Ratings agency from 10 August, the government's financing requirements in August–December 2011 are almost EUR1.1bn, against which it has EUR570mn of cash balances. The government's belief that it will be able to refinance the gap by borrowing from domestic banks may prove challenging at a time of deteriorating bank asset quality. International financing is unlikely under current market conditions (government three-year-bond yields exceeded 15% in August). Even if the government is able to secure financing until end-2011, it will enter 2012 with low cash balances and debt servicing due of EUR1.2bn in January-February. So there is little time left to implement the government's sensible fiscal deficit reduction plans in full and to work out a programme where funds for reconstruction of the destroyed power plant are made available from the EU as disaster support without a formal bail-out. In all, the probability of external official assistance (Euro-zone bail-out) becoming necessary in order to meet debt redemptions is considerable, exacerbated by the threat of a potential government bail-out of Cypriot banks that are highly exposed to Greece. If needed, such assistance is likely to be forthcoming since Cyprus is not big (0.2% of Euro-zone GDP) and should be manageable at the EU level. Total public debt stood at EUR10.6bn at end-2010.

The current account deficit remains a source of concern. It narrowed from 16.9% of GDP in 2008 to a still worrisome average annual 7.6% in 2009-2010 and is forecast to exceed 8% in 2011-2012. Adding to the concern is that net foreign direct investment (FDI) inflows covered only about one third of the external deficit in 2009-2010 and just 5% in Q1 2011. As a result, net external debt is estimated to have increased from just 4% of GDP in 2008 to a still favourable 12%. However, gross external debt has increased rapidly in recent years and stood at an estimated 450% of GDP at end-2010. Most of this is private-sector bank debt and includes non-resident deposits in the banking sector. According to the IMF, domestic banks' liquid assets cover about half of their short-term liabilities. Hence external liabilities are a source of external vulnerability despite the overall favourable net external debt position, such that fiscal and financial buffers are needed.

Banking Sector

The Cypriot banking sector is large and complex for a small economy owing to Cyprus' traditional role as an offshore financial centre for Russia, other CIS countries and the Middle East. There are currently 41 commercial banks—seven local banks and 34 subsidiaries or branches of foreign banks—and 100-odd cooperative credit institutions operating in Cyprus. Total banking sector assets account for more than ten times the GDP of Cyprus, or more than six times excluding subsidiaries and branches of foreign banks. The sector is also relatively concentrated, dominated by three domestic groups—the Bank of Cyprus, Marfin Popular Bank, and Hellenic Bank—which together hold about half of total banking assets. Greece's Alpha Bank is the predominant foreign player. The banking sector withstood the 2008-2009 global financial crisis relatively well, even though profitability came under some pressure and the share of non-performing loans in gross loans rose from a low of 3.2% in 2008 to 4.9% in March 2010. The main concern at that time was credit risk owing to banks' high exposure to the struggling construction and real estate sectors as well as to household debt which stood at 122% of GDP at end-2008.

Meanwhile, concerns about the banking sector have increased and shifted to its substantial exposure to Greece in the form of holdings of Greek sovereign bonds (estimated at EUR 8 bn), Greek bank bonds (EUR 5 bn), and lending to Greek companies and households through an extensive retail-banking network of Cypriot banks in Greece (EUR 30 bn by the two largest banks alone). Fitch estimates the banking sector's exposure to Greece at about 25% of its total assets.

The main risks that Cypriot banks face are:

- A "haircut" for creditors as a result of a Greek sovereign debt restructuring, which will cause losses and reductions in capitalisation levels. Participation in the proposed voluntary bond exchange programme that is part of the second Euro-zone package for Greece would already result in a 21% loss on Greek bonds (according to the IIF).
- The deteriorating operating environment in main markets (Greece, Cyprus).
- Continued asset quality deterioration, driven by rising NPLs in the Greek private sector.
- Deteriorating funding and liquidity profiles, exacerbated by downgrades by international credit rating agencies.
- The potential government bailout, which could damage the reputation of the Cypriot banking sector and result in the withdrawal of some of the overseas deposits that have left the banks well funded to date. Local depositors could also lose confidence.

The severity of the Greek crisis is threatening to destabilise not only the Cypriot banking sector, but also the country's public finances (if the government has to recapitalise banks) and the whole economy. Potential recapitalisation costs are estimated at up to 25% of GDP.

The two largest banks, Bank of Cyprus and Marfin Popular Bank, were subject to the 2011 EU-wide stress test conducted by the European Banking Authority (EBA) in mid-2011. The stress test assessed banks' capital adequacy against a 5% Core Tier 1 capital ratio benchmark under an adverse stress test scenario that was set by the ECB and covers a two-year time horizon (2011-2012). Both banks passed the stress test. The estimated consolidated Core Tier 1 capital ratio of Bank of Cyprus would change to 6.2% and for Marfin Popular Bank to 5.3% under the adverse scenario in 2012 compared to 8.1% and 7.3% respectively as of end of 2010. However, the test was again criticised for its lenience though not as roundly as in 2010. For example, under the so-called Basel III regime capital buffers will be measured against a 7% Core Tier 1 benchmark. Moreover, the stress test could not yet consider any voluntary participation in the Greek rescue plan. The EBA also said banks just above the pass mark (like Marfin) which had significant exposure to strained sovereign debt should also strengthen capital.

In all, it cannot be ruled out that Bank of Cyprus and Marfin Popular Bank may need some capital injection by the end of 2012. This would probably need to be done by the government. Under the new EFSF arrangements, however, EU funds could be made available. Below is some key information about the two banks.

Bank of Cyprus

- Moody's: Ba1 (negative outlook) LT deposit and debt ratings, downgraded from Baa2 on 28 July 2011. Earlier downgraded from A3 on 2 March 2011. Earlier downgraded from A2 on 5 July 2010.
- Fitch: BBB- (negative outlook), downgraded from BBB+ on 11 August 2011.

- Total consolidated assets: EUR 42.6 bn (end-2010)
- Exposure to Greek sovereign bonds: EUR 1.1 bn (end-June 2011, down from EUR 1.7 bn end-May 2011 and EUR 2.4 bn at end-2010). Bank of Cyprus intends to join the voluntary private sector plan to rescue Greece; it has written down EUR 281 mn (26%) in its H1 2011 financial results.
- Exposure to Greek private sector (loans to companies and households): EUR 11.2 bn (end-2010), of which EUR 1.0 bn were NPLs.
- EBA stress test: Successfully passed, and its Greek bonds were held at a 13% discount based on end-March prices. Core Tier 1 capital ratio was 8.2% at end-March 2011 but would fall to 6.2% under the 2-year adverse scenario.
- H1 2011 financial results:
Profit after tax, excluding impairment of Greek sovereign bonds: EUR 155 mn
Losses after tax, including impairment of Greek sovereign bonds: EUR 112 mn.

Marfin Popular Bank

- Moody's: Ba2 (negative outlook) for deposit and debt ratings, downgraded from Baa3 on 28 July 2011. Earlier downgraded from Baa2 on 2 March 2011. Earlier downgraded from A3 on 5 July 2010.
- Fitch: BBB- (negative outlook), downgraded on 1 June 2011 with a stable outlook, outlook changed to negative on 11 August 2011.
- Total consolidated assets: EUR 42.6 bn (end-2010)
- Exposure to Greek sovereign bonds: EUR 2.6 bn (end-June 2011, down from EUR 3.4 bn (end-2010). Marfin Popular Bank intends to join the voluntary private sector plan to rescue Greece; it has written down EUR 274 mn (10.5%) in its H1 2011 financial results which, however, appears too little.
- Exposure to Greek private sector (loans to companies and households): EUR 18.7 bn (end-2010), of which EUR 1.4 bn were NPLs.
- EBA stress test: Successfully passed. Marfin raised EUR 488 mn in a rights issue in February, which lifted its Core Tier 1 capital ratio to 9.4%, but it would fall to 5.3% under the 2-year adverse scenario.
- H1 2011 financial results:
Profit after tax, excluding impairment of Greek sovereign bonds: EUR 77 mn
Losses after tax, including impairment of Greek sovereign bonds: EUR 197 mn.

Structural Business Environment

The Structural Business Environment is strong. Cyprus scores excellent in terms of regulatory quality, rule of law and control of corruption in the World Bank's *2010 Governance Indicators* survey. The World Bank's *Doing Business 2011* survey ranks Cyprus 37th out of 183 countries. A remaining weakness is the occasional opacity of corporate transactions and balance sheets.

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Charts

