Country report

CYPRUS

Summary

Cyprus has performed relatively well in the face of the global recession. Although it especially suffered from reduced foreign demand, growth is expected to pick up, albeit slowly. That said, there is a concern that Cyprus is highly exposed to the crisis in Greece, as most Cypriot banks have a presence there. Also, both the local housing market and the tourism sector were affected by the crisis. Fiscal stimulation to both sectors caused the fiscal balance to deteriorate from +1% of GDP in 2008 to -6% of GDP in 2009. Overall, the current account's recovery is expected to be slow (with 6% of GDP deficit in 2010/11). The same can be said about the progress of reunification that has been stalled by the election of an anti-reunification president in Northern (Turkish) Cyprus.

Things to watch:

- Banking sector (exposure to Greece)
- Reunification process
- Twin deficit

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Cyprus

National facts	
Type of government	Republic
Capital	Nicosia
Surface area (thousand sq km)	9
Population (millions)	0,8
Main languages	Greek, Turkish, English
Main religions	Greek Orthodox (78%) Muslim (18%) Other (4%)
Head of State (president)	Demetris Christofias
Head of Government (prime-minist	Demetris Christofias
Monetary unit	euro (EUR)

Economy		2009
Economic size	*bn USD*	*% world total*
Nominal GDP	24	0,04
Nominal GDP at PPP	23	0,03
Export value of goods and services	12	0,08
IMF quotum (in mln SDR)	140	0,06
Economic structure	*2009*	*5-year av.*
Real GDP growth	-1,7	4,2
Agriculture (% of GDP)	2	2
Industry (% of GDP)	19	19
Services (% of GDP)	79	78
Standards of living	*USD*	*% world av.*
Nominal GDP per head	29144	318
Nominal GDP per head at PPP	28019	251
Real GDP per head	23075	297

Social and governance indicators	rank / total
Human Development Index (rank)	32/179
Ease of doing business (rank)	40/181
Economic freedom index (rank)	24/179
Corruption perceptions index (rank)	27/180
Press freedom index (rank)	25/169
Gini index (income distribution)	n.a.
Population below $1 per day (PPP)	n.a.

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Greece	17	Greece	18
Germany	7	Italy	10
UK	6	UK	8
Egypt	2	Germany	8
Main export products (%)			
Industrial products of manufacturing origin			n.a.
Raw agricultural products			n.a.
Processed agricultural products			n.a.
Industrial products of mineral origin			n.a.
Main import products (%)			
Intermediate goods			28
Consumer goods			34
Capital goods			11
Transport equipment			10
Openness of the economy			
Export value of G&S (% of GDP)			51
Import value of G&S (% of GDP)			51
Inward FDI (% of GDP)			25,0

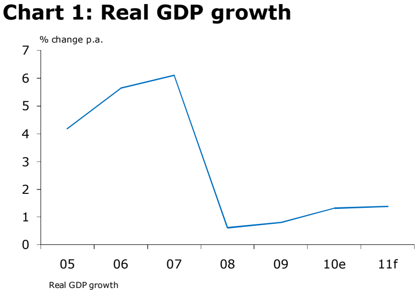
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Located just south of Turkey, Cyprus is both the third largest island in the Mediterranean Sea and the second smallest economy in the euro area. The main features of the Republic of Cyprus (hereafter referred to as Cyprus) are its small and open economy, the fact that it is part of the euro area, as well as its tourism and financial sectors. Its openness renders the Cypriot economy especially vulnerable to both demand and price shocks in the euro area and the UK. This explains why, despite earlier efforts to strengthen its financial and social institutions, Cyprus too has felt the consequences of the global financial turmoil. Although Cyprus stayed clear of many of the financial wrongs (i.e. toxic assets) that underlie the crisis, it was affected by reduced demand in especially the UK, Russia and Greece. In 2008, GDP growth started to decline, turning negative in 2009. The first quarter of 2010 showed slightly positive (nominal) growth of 0.1%, which is still far below the average growth rate of 3.7% (2000-2007). The positive growth rate in 2009 is a result of inventory changes and a public stimulus package. Real GDP growth remained negative at around -0.8% (Q1). In 2010 growth is expected to stay close to zero, only to pick up in 2011-12.
Traditionally, growth is derived from three main sectors: tourism, financial services and construction. Tourism constitutes over 16% of GDP and is generally perceived as the main growth sector. Most tourists arrive from the UK. However, with the UK still recovering from its recession, tourism in Cyprus has fallen (11% less arrivals), causing tourist receipts to fall by 17%. Clearly, a reversal of this trend clings on further economic recovery in the UK. The construction sector mainly services tourism and is indirectly affected by the decrease in arrivals and foreign demand for real

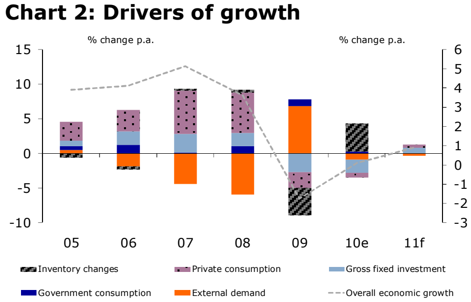
estate. Contraction in the real estate sector also impacted the financial sector, through an increase in non-performing loans. The collapse of the housing market in 2008-2009 thus directly impacted the financial sector. Nonetheless, foreign interest in the real estate market, and subsequently the number of sales, recently increased by 18.5% (yoy in the first quarter of 2010).
Indeed, the financial service sector contracted as well, mainly due to the debt crisis in Greece. Around one third of all deposits and banking assets are obtained from Greece. Also, Cypriot banks hold EUR 5.5bn (March 2010) in Greek bonds. Aside from Greece, Russia, the UK and Australia together hold around 7% of all assets in Cypriot banks. Economic problems in these countries have caused depositors to withdraw funds from these banks. However, the risk of sudden capital outflows should not be overstated. High liquidity requirements, a strong deposit base domestically and a generally conservative banking system should allow the sector to overcome many adversities. This was also the outcome of the recent stress-test.
A slowdown in credit expansion (to 8.8% in December 2009), signals a reduction in domestic demand. Especially demand for housing loans has fallen. In 2009, private consumption fell by 3% and this contraction is expected to continue in 2010 (-1% pa). Reduced employment likely contributes to reduced consumption. Initially, public consumption remained high, as the government actively stimulated the economy with a stimulus package of around 1.5% of GDP. Although these measure make sense in light of economic circumstances, they result in a budget deficit of 6% of GDP. This implies that the level of spending will be unsustainable in the long run and has to be reduced. Obviously, this will further trim down domestic demand. Given low demand, one would expect inflation to be low as well. This is not the case. Estimated inflation for 2010, 2.4%, lies above that in 2009 and inflation is projected to increase further. Now that the global economy is slowly recovering the oil price is likely to accelerate as well, driving up inflation. Potential increases in grain, vegetable and fruit prices further add to the price level. This implicates a further divergence from the euro area average.

Chart 1: Real GDP growth



Source: EIU

Chart 2: Drivers of growth



Source: EIU

Political and social situation

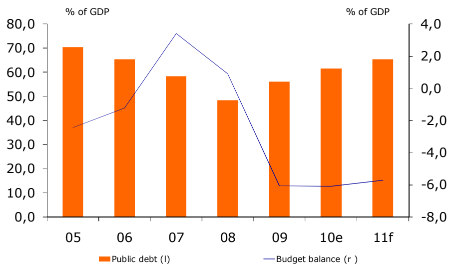
Unfortunately, the island's political and social situation is dominated by a *de facto* political and geographical partition. Since 1974, the Turkish Cypriots controls the northern part of the island, whereas the Greek oriented Republic of Cyprus controls the south. So far, efforts to settle this dispute have failed and tensions between both parts remain. The possibility of a settlement in the near future is severely limited by the political directions of the party currently in charge of the Turkish Republic of Northern Cyprus (TRNC).
The current president of the republic of Cyprus, Demetris Christofias, came into office in 2008. In his inauguration speech Chritofias expressed hopes of re-unifying the island. During the past two years, Christofias has continued to display an interest in re-unification. For one, he did away with

legal action against the European Union and thereby enabled EU aid to reach northern Cyprus. In this and other respects his actions differ greatly from those of his predecessor, Tassos Papadopoulos, who fiercely opposed a UN peace plan in 2004. On the other part of the island, Talat, former president of the TRNC, also seemed willing to negotiate a peace deal. Unfortunately, despite all this good will, an agreement was never reached. Since April 2010, the window of opportunity closed once again, when Eroglu became the new president of the TRNC. Under his rule, it seems highly unlikely that further peace talks will be fruitful. Whereas Christofias supports unification, Eroglu is in favour of a two state solution. For this reason it seems highly unlikely that a new round of negotiations, commenced by Christofias in August, will yield better results.
The failure to reach an agreement has little to do with the lack of support given by international organizations and neighbour countries. Instead, the division of Cyprus brings with it a more international dimension. Although the conflict started out as a turf dispute between Turkey and Greece, both countries now have an incentive to resolve the issue as soon as possible. For Turkey, ending the conflict is a requirement for its accession to the EMU. Surprisingly, the failure to reach an agreement did prevent Cyprus to enter the EMU. Moreover, as an EMU member, Cyprus can vote for or against Turkish accession. Greece on the other hand, has intensified its trade relations with Turkey and wishes to increase trade further. Re-unification could help achieve that.
Nonetheless, we do not expect any structural changes in the coming year(s). Although the de facto partition of north and south underlies internal, as well as external politics, some mention should be made regarding the internal social and political situation. Politically, the large number of small political fractions tends to delay the political process. In addition, corruption continues to augment the cost of doing business. Socially, after the partition many Greek Cypriots became internally displaced. They are now taking legal action to regain their properties, which has caused friction between both sides. Turkish Cypriots in the north are now living in the former houses of Greek Cypriots. Allowing the Greek Cypriots to retake their properties will therefore put Turkish Cypriots out of their homes. This issue is also unlikely to be resolved in the coming year.

Economic policy

Before the recession, as a prerequisite for joining the EMU, Cyprus had implemented a series of reforms aimed at liberalizing trade and capital flows and to stabilize its public debt and budget deficits. To this end, the government cut expenditures and even created a budget surplus in 2007. Until 2009, it has managed to maintain deficits and debt within EMU guidelines (3% and 60%). However, due to the global crisis, the public deficit and public debt have both increased. The global crisis revealed some of Cyprus' weaknesses such as its large public sector and high public wages. The crisis and especially the situation in Greece furthered the deficit by reducing tax revenues and causing the government to spend an extra 1.5% of GDP on a fiscal stimulus package (mainly allocated to the real estate sector). As a result, both the public debt and the budget deficit surpassed the Maastricht criteria. Of course, Cyprus is not the exception and instead outperformed many EMU members. Moreover, as part of the EU's excessive debt procedure (EDP), Cyprus is now required to lower its deficit to 3% of GDP in 2012. This measure should also reduce its debt to (less than) 60% of GDP. The target is ambitious, but not impossible to reach. It does require some extensive measures that may also present some social and political costs. In this respect, the fact that the government managed to cut its deficit in the past, bodes well for the future. That said, there is some cause for concern. As mentioned, Cyprus has a large bureaucracy and spends too much on relatively high public wages. Moreover, its ageing population exerts pressure on the sustainability of its social security scheme. The percentage of people over 65 is expected to rise to 20% in 2030 In order to ease the impact of this demographic shift, it is vital to reform the social security system. Although some reforms have been implemented (most notably a raise in contribution rates), more extensive reforms are needed to guarantee a sustainable fiscal position. An upward adjustment of the retirement age would be a good place to start. Finally, recurring risks of water shortages could translate into higher deficits as water would need to be imported. However, after a severe drought in 2008, the government is working on enhancing the capacity of its desalination plants. Unfortunately, returns to these investments will take time to materialize.

Chart 3: Public Finances



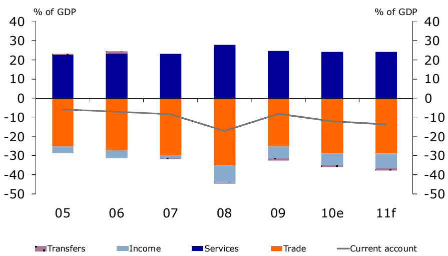
Source: EIU

Balance of Payments

Cyprus has long struggled with twin deficits: the budget deficit described above, as well as a current account deficit. Despite reduced foreign demand, the current account improved remarkably during last year. Unfortunately, this improvement came mostly from reduced domestic demand and a drop in oil prices. Furthermore, as the euro became weaker, Cyprus gained a competitive edge in return. This caused the trade deficit to improve somewhat, to 25% of GDP, which is still substantial. Of course, none of these developments changed the real causes underlying historical current account deficits. For this reason, it seems likely that once global economic recovery sets in and oil prices start to increase, Cyprus' current account deficit will widen. Indeed, it is expected to reach 12% of GDP in 2010, and increase to 13.7% in 2011 from 8.1% in 2009. Even though part of the deficit originates from the import of investment goods, it is mostly a consequence of a lack of competitive power. Relatively high wages put Cyprus at a disadvantage relative to other emerging EU-members. In general, Cyprus should reform its export sector and labour market in order to stay ahead of – or at least keep up with – the curve. This argument also relates to the services balance. Although (tourism and financial) services contributed positively to the current account balance, regional competition (in the tourism sector) will likely intensify, as tourism in the Baltics takes off. To maintain a (large) services account surplus, these developments need to be taken into account.

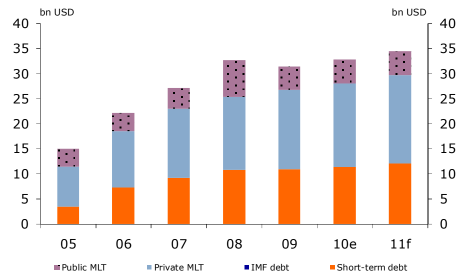
Finally, fluctuating income and transfer balances tend to only widen the current account deficit. This is partly caused by Cyprus' role as a financial hub: interest is paid to foreigners holding deposit and savings accounts in Cypriot banks. In addition, an influx of seasonal workers (in the tourism and agriculture sectors) causes an outflow of income. Together, these flows add to the deficit.

Chart 4: Decomposition of Current Account Balance



Source: EIU

Chart 5: Decomposition of external debt



Source: EIU

External position

Cyprus has a large and increasing external debt ratio: 163% of GDP. Compared to other EMU countries this ratio seems excessive. Compared to other financial hubs, the ratio is quite normal Especially considering that around 90% is held by banks. Of course, there are still risks. For one, a sudden withdrawal of foreign deposit holders could threaten banks. However, the chance that such a loss of confidence will occur, is very small, as Cypriot's financial system is relatively stable and well-monitored. There is a greater risk of depositors withdrawing their money simply because they need it at home, as already occurred last year. In this case the resulting cash outflow would be smaller and more manageable. As mentioned before, the occurrence of such an event mainly depends on developments in Greece. In any event, it seems unlikely that Cyprus will be pushed in the same direction as Iceland two years ago. Whereas Iceland attracted investors with high interest rates, Cyprus mainly offers them low taxes. Furthermore, Cypriot banks are bound by larger capital requirements than most European banks and Cyprus is part of the EMU and as such is able to borrow at lower costs.

Of course, its EMU membership did have an impact on the liquidity rate. Adopting the euro meant that large reserves were no longer necessary and as a result, foreign exchange reserves decreased considerably. Recently, reserves have been increasing, which positively affected the liquidity ratio. That said, the ratio is expected to decline somewhat, but given the fact that Cyprus is an EMU member, this should not be of much concern.

Cyprus

Selection of economic indicators	2005	2006	2007	2008	2009	2010e	2011f
Key country risk indicators							
GDP (% real change pa)	3,9	4,1	5,1	3,6	-1,7	0,1	0,9
Consumer prices (average % change pa)	2,6	2,5	2,4	4,7	0,4	2,4	2,4
Current account balance (% of GDP)	-5,8	-7,1	-8,4	-17,2	-8,1	-12,0	-13,7
Total foreign exchange reserves (mln USD)	4191	5647	6119	617	796	1320	1390
Economic growth							
GDP (% real change pa)	3,9	4,1	5,1	3,6	-1,7	0,1	0,9
Gross fixed investment (% real change pa)	4,1	10,2	13,4	8,6	-12,0	-9,0	4,0
Private consumption (real % change pa)	4,2	4,7	9,4	8,4	-3,0	-1,0	0,7
Government consumption (% real change pa)	3,4	7,3	0,3	6,2	5,8	1,0	0,0
Exports of G&S (% real change pa)	4,9	3,5	6,1	-2,1	-11,8	1,7	1,7
Imports of G&S (% real change pa)	3,7	6,7	13,3	8,0	-19,8	3,2	2,1
Economic policy							
Budget balance (% of GDP)	-2,5	-1,2	3,4	0,9	-6,1	-6,1	-5,7
Public debt (% of GDP)	70	65	58	48	56	62	65
Money market interest rate (%)	3,3	2,9	4,0	4,6	1,2	0,8	0,9
M2 growth (% change pa)	11	13	19	20	-3	1	3
Consumer prices (average % change pa)	2,6	2,5	2,4	4,7	0,4	2,4	2,4
Exchange rate LCU to USD (average)	0,8	0,8	0,7	0,7	0,7	0,8	0,8
Recorded unemployment (%)	5,3	4,5	3,9	3,6	5,3	6,0	6,4
Balance of payments (mln USD)							
Current account balance	-971	-1279	-1831	-4349	-1915	-2570	-2900
Trade balance	-4247	-4942	-6474	-8933	-5907	-6130	-6150
Export value of goods	1545	1393	1483	2130	2065	2100	1820
Import value of goods	5792	6335	7957	11063	7973	8220	7970
Services balance	3796	4221	5039	7052	5814	5180	5120
Income balance	-612	-765	-383	-2359	-1543	-1370	-1620
Transfer balance	92	206	-14	-108	-278	-250	-250
Net direct investment flows	614	976	1032	64	608	1970	1220
Net portfolio investment flows	-53	-149	-497	-17742	-16687	-3030	-2860
Net debt flows	1458	4703	3069	4205	1506	1980	2420
Other capital flows (negative is flight)	-733	-2738	-1208	12317	16444	1670	2170
Change in international reserves	315	1513	565	-5505	-44	30	60
External position (mln USD)							
Total foreign debt	14967	22132	27080	32613	31421	32800	34470
Short-term debt	3440	7248	9150	10752	10835	11300	12050
Total debt service due, incl. short-term debt	3312	4110	8211	10815	12284	12520	13000
Total foreign exchange reserves	4191	5647	6119	617	796	1320	1390
International investment position	3211	7279	2892	969	n.a.	n.a.	n.a.
Total assets	47757	71367	91976	110830	n.a.	n.a.	n.a.
Total liabilities	44546	64088	89084	109861	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-25,3	-27,3	-29,8	-35,2	-25,0	-28,7	-29,1
Current account balance (% of GDP)	-5,8	-7,1	-8,4	-17,2	-8,1	-12,0	-13,7
Inward FDI (% of GDP)	6,9	10,3	10,6	15,2	25,0	12,9	10,2
Foreign debt (% of GDP)	89	122	125	129	133	153	163
Foreign debt (% of XGSIT)	145	192	177	170	197	225	244
International investment position (% of GDP)	19,1	40,2	13,3	3,8	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	32	36	54	56	77	86	92
Interest service ratio incl. arrears (% of XGSIT)	3	3	4	7	8	10	10
FX-reserves import cover (months)	5,9	7,3	6,3	0,5	0,8	1,3	1,4
FX-reserves debt service cover (%)	127	137	75	6	6	11	11
Liquidity ratio	333	401	367	208	254	237	224

Source: EIU