



## Summary

The Cypriot economy is deteriorating at an alarming speed. As the country's large financial sector is heavily exposed to Greek debt, its banks have been struggling to remain solvent after having to write-off a significant part of their Greek sovereign debt holdings. Unfortunately, the government is not in a position to grant bailouts. After having its rating reduced to junk status, the Cypriot government saw its costs of borrowing shoot through the roof, raising public debt to an expected 80% of GDP in 2012 (from 72% of GDP in 2011). As a result, the government was forced to request a EU bailout last June and is expected to need EUR 11bn. Although negotiations are still ongoing, we expect the bailout to be granted. However, disagreement between the Cypriot government and the Troika on the severity of the austerity measures attached to the bailout, could delay the negotiations. This would put additional pressure on the financial sector. Meanwhile, we expect the economy to remain in recession, contracting by around 1.2% in 2012.

## Things to watch:

- Rescue package negotiations with Troika
- Stability of the financial sector
- Greek debt crisis developments

Author: **Anouk Ruhaak**  
Country Risk Research  
Economic Research Department  
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands  
+31-(0)30-21-64860  
[A.N.Ruhaak@rn.rabobank.nl](mailto:A.N.Ruhaak@rn.rabobank.nl)

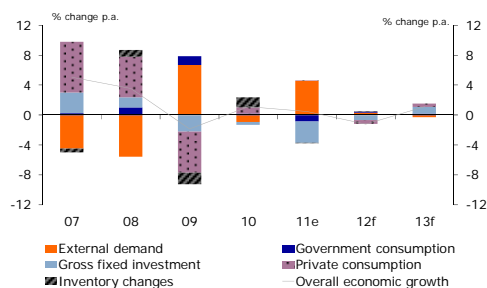
| Cyprus                             |                      |   |          |
|------------------------------------|----------------------|---|----------|
| <b>National facts</b>              |                      | <b>Social and governance indicators</b>     |          |
| Type of government                 | Republic             | Human Development Index (rank)              | 35 / 169 |
| Capital                            | Nicosia              | Ease of doing business (rank)               | 37 / 183 |
| Surface area (thousand sq km)      | 9                    | Economic freedom index (rank)               | 18 / 179 |
| Population (millions)              | 0.8                  | Corruption perceptions index (rank)         | 28 / 178 |
| Main languages                     | Greek, Turkish       | Press freedom index (rank)                  | 45 / 178 |
| Main religions                     | English              | Gini index (income distribution)            | n.a.     |
|                                    | Greek orthodox (78%) | Population below \$1.25 per day (PPP)       | n.a.     |
|                                    | Muslim (18%)         |   |          |
| Other (4%)                         |                      |   |          |
| Head of State (president)          | Demetris Christofias | <b>Foreign trade</b>                        |          |
| Head of Gov (prime-minister)       | Demetris Christofias | <b>2011</b>                                 |          |
| Monetary unit                      | euro (EUR)           | <b>Main export partners (%)</b>             |          |
|                                    |                      | <b>Main import partners (%)</b>             |          |
|                                    |                      | Greece                                      | 21       |
|                                    |                      | Greece                                      | 19       |
|                                    |                      | Germany                                     | 8        |
|                                    |                      | Italy                                       | 8        |
|                                    |                      | UK  | 9        |
|                                    |                      | UK  | 8        |
|                                    |                      | Egypt                                       | 2        |
|                                    |                      | Germany                                     | 9        |
| <b>Economy</b>                     |                      | <b>2011</b>                                 |          |
| <b>Economic size</b>               |                      | <b>Main export products (%)</b>             |          |
|                                    | <i>bn USD</i>        | <b>2010</b>                                 |          |
| Nominal GDP                        | 25                   | Industrial products of manufacturing origin |          |
| Nominal GDP at PPP                 | 24                   | Raw agricultural products                   |          |
| Export value of goods and services | 11                   | Processed agricultural products             |          |
| IMF quatum (in mln SDR)            | 158                  | Industrial products of mineral origin       |          |
|                                    | 0.07                 | <b>Main import products (%)</b>             |          |
|                                    |                      | <b>2010</b>                                 |          |
| <b>Economic structure</b>          |                      | <b>2011</b>                                 |          |
|                                    | <b>2011</b>          | <b>5-year av.</b>                           |          |
| Real GDP growth                    | 0.5                  | 2.4   |          |
| Agriculture (% of GDP)             | 2                    | 2   |          |
| Industry (% of GDP)                | 16                   | 18  |          |
| Services (% of GDP)                | 81                   | 80  |          |
| <b>Standards of living</b>         |                      | <b>Openness of the economy</b>              |          |
|                                    | <i>USD</i>           | <b>2011</b>                                 |          |
| Nominal GDP per head               | 30174                | 279   |          |
| Nominal GDP per head at PPP        | 29024                | 234   |          |
| Real GDP per head                  | 23025                | 283   |          |
|                                    |                      | Export value of G&S (% of GDP)              |          |
|                                    |                      | 43  |          |
|                                    |                      | Import value of G&S (% of GDP)              |          |
|                                    |                      | 46  |          |
|                                    |                      | Inward FDI (% of GDP)                       |          |
|                                    |                      | 8.5   |          |

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

### Introduction and update

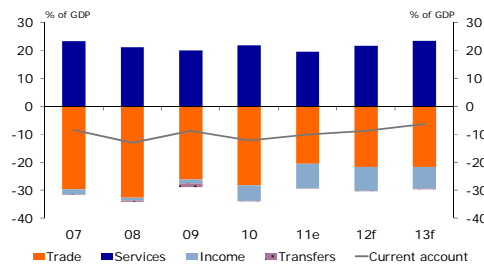
Cyprus is rapidly moving from one crisis to another. Following the energy crisis last year, brought on by a fire in the country's largest power plant, Cyprus is now coping with a banking and sovereign debt crisis. At the same time, the economy has entered into a recession. Estimates show that the economy contracted by a seasonally adjusted 1.5% yoy in 12Q1 and 2.4% yoy in 12Q2. Despite a small rise in tourism, we saw almost all other sectors contract, including construction, manufacturing and retail. Underlying the recession is a drop in domestic demand, brought on by reduced public spending, an increase in unemployment and a fall in credit available to the private sector. For 2012 as a whole we expect the economy to contract by around 1.2%. Whether GDP growth will return in 2013 will largely depend on the severity of the austerity measures that are to be implemented by the government (see below).

Figure 1: Growth performance



Source: EIU

Figure 2: Current account



Source: EIU

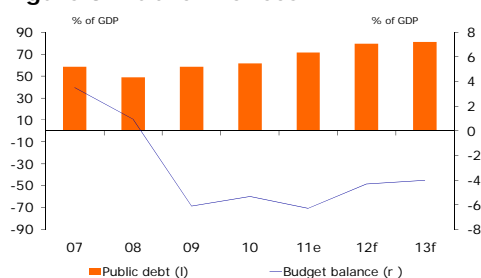
On a more positive note, the drop in domestic demand helped to lower imports, resulting in a shrinking trade deficit. In addition, the rise in tourism revenues further helped reduce the current account deficit. Still, as the banking sector remains in poor health, we expect the surplus on the services balance to decline in 2012. In addition, high interest payments on public debt will add to the income deficit. Together, these trends will largely offset the declining trade deficit, resulting in an expected current account deficit of 9% of GDP in 2012, compared to 10% of GDP in 2011. In the past, this deficit was largely financed by investment inflows, which have so far remained stable. However, this could easily change.

### Banks in distress

Last June, the Cypriot government formally requested an EU bailout, as well as a EUR 5bn loan from Russia. It is estimated that the government could need as much as EUR 11bn in total. These funds would be employed to refinance government debt and recapitalize the banking sector. The need for a bailout was widely anticipated, as Cyprus' large financial sector is heavily exposed to Greek sovereign debt. In fact, debt holdings of Cyprus' largest 3 banks consists for roughly 40% of Greek debt. After having to write-off a large part of these debt holdings, banks are now turning to the government for a rescue package. However, given the enormous size of Cyprus' financial sector relative to GDP (with total bank assets amounting to over 860% of GDP), the government will not be able to provide such a bailout.

To make matters worse, the poor state of the banking sector combined with the local energy crisis forced the three largest rating agencies to downgrade the Cypriot sovereign debt rating to junk status at the start of 2012. Consequently, borrowing costs shot through the roof. In addition, both the energy and banking crises have added to public spending, pushing public debt to 72% of GDP in 2011, from 61% of GDP in 2010. Without a bailout, it is highly unlikely that the government will be able to refinance the EUR 4.5bn in debt that will come due before 2014.

Figure 3: Public finances



Source: EIU

Although we fully expect a bailout to take place, its timing remains uncertain. As a condition for receiving a bailout, the troika has demanded that the government implements EUR 1bn in spending cuts. These would include a cut in public wages and pensions. The government's reluctance to give in to these demands could delay the realization of a bailout. As Russia also indicated that its decision to extend a loan would partly depend on Cyprus' negotiations with the Troika, a delay would leave Cyprus strapped for cash and thus unable to rescue its banks. In this scenario, a full collapse of the financial sector (including a bank run) would be a real possibility.



| Cyprus  |       |        |        |        |        |       |       |
|---|-------|--------|--------|--------|--------|-------|-------|
| Selection of economic indicators  | 2007  | 2008   | 2009   | 2010   | 2011   | 2012e | 2013f |
| <i>Key country risk indicators</i>  |       |        |        |        |        |       |       |
| GDP (% real change pa)  | 5.1   | 3.6    | -1.9   | 1.1    | 0.5    | -1.2  | 0.5   |
| Consumer prices (average % change pa)   | 2.4   | 4.7    | 0.4    | 2.4    | 3.3    | 3.4   | 2.4   |
| Current account balance (% of GDP)  | -8.4  | -15.4  | -10.6  | -10.0  | -10.3  | -8.9  | -7.3  |
| Total foreign exchange reserves (mln USD)   | 6119  | 617    | 796    | 515    | 504    | n.a.  | n.a.  |
| <i>Economic growth</i>  |       |        |        |        |        |       |       |
| GDP (% real change pa)  | 5.1   | 3.6    | -1.9   | 1.1    | 0.5    | -1.2  | 0.5   |
| Gross fixed investment (% real change pa)   | 13.4  | 6.0    | -9.7   | -1.7   | -13.8  | -4.0  | 5.0   |
| Private consumption (real % change pa)  | 10.2  | 7.8    | -7.5   | 1.3    | 0.2    | -0.6  | 0.6   |
| Government consumption (% real change pa)   | 1.3   | 6.1    | 6.8    | 0.8    | -4.7   | -1.5  | -4.5  |
| Exports of G&S (% real change pa)   | 6.2   | -0.5   | -10.7  | 3.7    | 3.6    | 3.2   | 3.9   |
| Imports of G&S (% real change pa)   | 13.4  | 8.5    | -18.6  | 4.9    | -5.0   | 2.8   | 3.3   |
| <i>Economic policy</i>  |       |        |        |        |        |       |       |
| Budget balance (% of GDP)   | 3.5   | 0.9    | -6.1   | -5.3   | -6.3   | -4.3  | -4.2  |
| Public debt (% of GDP)  | 59    | 49     | 59     | 61     | 72     | 81    | 84    |
| Money market interest rate (%)  | 4.0   | 4.6    | 1.2    | 0.8    | 1.4    | 0.7   | 0.7   |
| M2 growth (% change pa)   | 18    | 10     | -1     | 3      | 3      | -3    | 2     |
| Consumer prices (average % change pa)   | 2.4   | 4.7    | 0.4    | 2.4    | 3.3    | 3.4   | 2.4   |
| Exchange rate LCU to USD (average)  | 0.7   | 0.7    | 0.7    | 0.8    | 0.7    | 0.8   | 0.8   |
| Recorded unemployment (%)   | 4.0   | 3.8    | 5.5    | 6.4    | 7.9    | 8.0   | 8.0   |
| <i>Balance of payments (mln USD)</i>  |       |        |        |        |        |       |       |
| Current account balance   | -1831 | -3878  | -2480  | -2309  | -2546  | -1960 | -1620 |
| Trade balance   | -6474 | -8186  | -5982  | -6185  | -6043  | -5830 | -6180 |
| Export value of goods   | 1483  | 1753   | 1395   | 1509   | 1957   | 1890  | 1990  |
| Import value of goods   | 7957  | 9939   | 7376   | 7694   | 8000   | 7720  | 8170  |
| Services balance  | 5039  | 5303   | 4701   | 4742   | 5151   | 5350  | 6110  |
| Income balance  | -383  | -899   | -929   | -710   | -1366  | -1230 | -1280 |
| Transfer balance  | -14   | -95    | -271   | -156   | -288   | -260  | -280  |
| Net direct investment flows   | 1032  | -1311  | 3129   | 115    | 1100   | 1200  | 1300  |
| Net portfolio investment flows  | -497  | -17746 | -24554 | -4428  | -4769  | -980  | 240   |
| Net debt flows  | 3068  | 67600  | n.a.   | n.a.   | n.a.   | n.a.  | n.a.  |
| Other capital flows (negative is flight)  | -1208 | -50169 | n.a.   | n.a.   | n.a.   | n.a.  | n.a.  |
| Change in international reserves  | 565   | -5505  | 286    | -145   | 63     | n.a.  | n.a.  |
| <i>External position (mln USD)</i>  |       |        |        |        |        |       |       |
| Total foreign debt  | 27080 | 103176 | 131467 | 113584 | 106534 | n.a.  | n.a.  |
| Short-term debt   | 9150  | 74147  | 100163 | 78844  | 68443  | n.a.  | n.a.  |
| Total debt service due, incl. short-term debt                                       | 8211  | 10815  | 75970  | 102128 | 81565  | n.a.  | n.a.  |
| Total foreign exchange reserves   | 6119  | 617    | 796    | 515    | 504    | n.a.  | n.a.  |
| International investment position   | 2892  | -3609  | n.a.   | n.a.   | n.a.   | n.a.  | n.a.  |
| Total assets  | 91976 | 119552 | n.a.   | n.a.   | n.a.   | n.a.  | n.a.  |
| Total liabilities   | 89084 | 123161 | n.a.   | n.a.   | n.a.   | n.a.  | n.a.  |
| <i>Key ratios for balance of payments, external solvency and external liquidity</i> |       |        |        |        |        |       |       |
| Trade balance (% of GDP)  | -29.8 | -32.4  | -25.5  | -26.9  | -24.4  | -26.4 | -27.9 |
| Current account balance (% of GDP)  | -8.4  | -15.4  | -10.6  | -10.0  | -10.3  | -8.9  | -7.3  |
| Inward FDI (% of GDP)   | 10.6  | 5.3    | 15.1   | 3.6    | 8.5    | 10.0  | 10.2  |
| Foreign debt (% of GDP)   | 125   | 409    | 560    | 494    | 431    | n.a.  | n.a.  |
| Foreign debt (% of XGSIT)   | 177   | 641    | 929    | 843    | 930    | n.a.  | n.a.  |
| International investment position (% of GDP)  | 13.3  | -14.3  | n.a.   | n.a.   | n.a.   | n.a.  | n.a.  |
| Debt service ratio (% of XGSIT)   | 54    | 67     | 537    | 758    | 712    | n.a.  | n.a.  |
| Interest service ratio incl. arrears (% of XGSIT)                                   | 4     | 8      | 9      | 8      | 14     | n.a.  | n.a.  |
| FX-reserves import cover (months)   | 6.3   | 0.5    | 0.9    | 0.6    | 0.5    | n.a.  | n.a.  |
| FX-reserves debt service cover (%)  | 75    | 6      | 1      | 1      | 1      | n.a.  | n.a.  |
| Liquidity ratio   | 367   | 222    | 78     | 49     | 58     | n.a.  | n.a.  |

Source: EIU

**Disclaimer**

This document is issued by Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. incorporated in the Netherlands, trading as Rabobank Nederland, and regulated by the FSA. The information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but no representation or warranty, express or implied, is made as to their accuracy or completeness. It is for information purposes only and should not be construed as an offer for sale or subscription of, or solicitation of an offer to buy or subscribe for any securities or derivatives. The information contained herein is not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient. All opinions expressed herein are subject to change without notice. Neither Rabobank Nederland, nor other legal entities in the group to which it belongs accept any liability whatsoever for any direct or consequential loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith, and their directors, officers and/or employees may have had a long or short position and may have traded or acted as principal in the securities described within this report, or related securities. Further it may have or have had a relationship with or may provide or have provided corporate finance or other services to companies whose securities are described in this report, or any related investment. This document is for distribution in or from the Netherlands and the United Kingdom, and is directed only at authorised or exempted persons within the meaning of the Financial Services and Markets Act 2000 or to persons described in Part IV Article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2001, or to persons categorised as a "market counterparty or intermediate customer" in accordance with COBS 3.2.5. The document is not intended to be distributed, or passed on, directly or indirectly, to those who may not have professional experience in matters relating to investments, nor should it be relied upon by such persons. The distribution of this document in other jurisdictions may be restricted by law and recipients into whose possession this document comes from should inform themselves about, and observe any such restrictions. Neither this document nor any copy of it may be taken or transmitted, or distributed directly or indirectly into the United States, Canada, and Japan or to any US-person. This document may not be reproduced, distributed or published, in whole or in part, for any purpose, except with the prior written consent of Rabobank Nederland. By accepting this document you agree to be bound by the foregoing restrictions.