



Summary

Cyprus looks well on its way of becoming the fourth euro zone country that needs a rescue package. The destruction of a large power plant in July has resulted in an energy crisis with a severe impact on economic growth and the government budget. Meanwhile, the large Cypriote banking sector may need official support due to its large exposure to Greek sovereign and banking debt. Given the large refinancing needs in early 2012, it is doubtful whether the government will be able to provide this official assistance. After a political crisis a new government took power in early August. As this government only has a minority in parliament, it remains to be seen whether it will be able to implement fiscal cuts necessary to rein in a sizeable deficit. Efforts to reform the large and inefficient public sector are thwarted by the close ties between the ruling Communist party and the very powerful trade unions. Furthermore, Cyprus has to reinvent its growth model. The conditions tied to possible outside support may make the economy less attractive as an offshore financial centre. What is more, it may be necessary to downsize the banking sector, given the limited ability of a small country such as Cyprus to protect its relatively large financial sector.

Things to watch:

- Government's ability to deal with the energy crisis and implement a credible austerity plan
- Impact of crisis in Greece

Author: **Herwin Loman**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-31105
H.Loman@rn.rabobank.nl

Cyprus						
National facts			Social and governance indicators rank / total			
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%)		Foreign trade 2010			
Head of State (president)	Demetris Christofias		<i>Main export partners (%)</i> <i>Main import partners (%)</i>			
Head of Gov (prime-minister)	Demetris Christofias		Greece	21	Greece	17
Monetary unit	Euro (EUR)		Germany	9	Italy	8
			UK	7	UK	8
			Egypt	2	Germany	7
Economy 2010			Main export goods and services (%) 2010			
<i>Economic size</i> <i>bn USD</i> <i>% world total</i>			<i>Main import products (%)</i> 2009			
Nominal GDP	23	0.04	Other business services	25		
Nominal GDP at PPP	23	0.03	Travel	22		
Export value of goods and services	12	0.07	Transport	20		
IMF quatum (in mln SDR)	140	0.06	Goods	16		
<i>Economic structure</i> 2010 5-year av.			<i>Openness of the economy</i> 2010			
Real GDP growth	1.0	3.0	Export value of G&S (% of GDP)	53		
Agriculture (% of GDP)	2	2	Import value of G&S (% of GDP)	54		
Industry (% of GDP)	17	19	Inward FDI (% of GDP)	8.6		
Services (% of GDP)	81	79				
<i>Standards of living</i> <i>USD</i> <i>% world av.</i>						
Nominal GDP per head	28547	289				
Nominal GDP per head at PPP	28526	243				
Real GDP per head	23305	292				

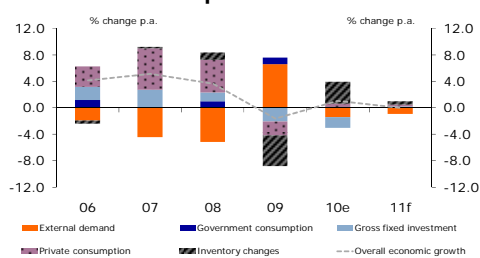
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

The economic situation in Cyprus has deteriorated significantly in the past months. Cyprus has been suffering electricity shortages since the July 11 explosion at a munitions depot on the east Mediterranean island's southern coast. The explosion killed 13 people and knocked out the nearby 767-megawatt Vasilikos power station. The plant supplied about half of the country's power generation capacity. The economic damage is likely to be huge, as the total cost, including the damage to the important tourist industry, may rise to EUR 2.4bn, which is almost 15% of GDP. The central bank governor even said that the economy is now facing a crisis similar to the one Cyprus faced when Turkey invaded the island. The government has already indicated that growth in 2011 is likely to be around 0%, against an estimate of 1.5% growth before the accident. The accident is also likely to have a big impact on the government budget. The government has warned that without fiscal measures, the fiscal deficit will be 6.5% of GDP, while estimates made before the energy crisis put the deficit at 4.5% of GDP. Confronted with this energy crisis Cyprus is in need of an effective government. Unfortunately, this is precisely what is lacking at the moment. In late July president Demetris Christofias dissolved his government, after the two remaining ministers of the Democratic party, the junior party within the former government, resigned. In early August Christofias appointed a new cabinet consisting solely of his Communist (AKEL) party. However, this new government does not enjoy a majority in parliament. The new finance minister Kikis Kazamias has made an austerity plan which aims to cut the fiscal deficit by EUR 150mln in 2011 and EUR 600mln in 2012. Parliament will vote on the new plan on 25 August. It remains to be seen whether

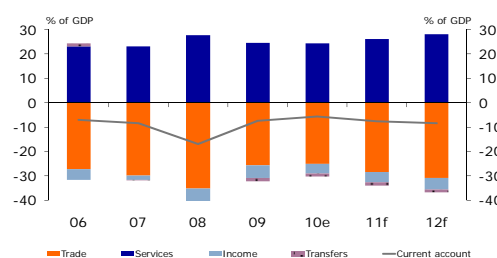
the government will be able to get its austerity plan approved, as the opposition parties have already indicated that the plan relies too much on tax increases and does not include a reform of the costly public pension system. The government reached an agreement with the very powerful public sector unions on reforms of the large and inefficient public sector. However, this agreement does not include any reforms to the public pension system. In light of the opposition within parliament it remains to be seen whether the government will be able to implement the austerity package. Opposing the public unions may be dangerous, given the extreme high unionization rate of 70%.

Chart 1: Growth performance



Source: EIU & Rabobank estimates

Chart 2: Current account deficit



Source: EIU

Next in line?

Meanwhile, the extremely large banking sector has become a big vulnerability for the small economy. Banking assets are equal to 600% of GDP or even 860% of GDP once the subsidiaries and branches of foreign banks are included. The banks still have relatively high liquidity and capital ratios, but their capital buffers may soon be wiped out, as Cypriot banks hold about EUR 31bn (equal to 170% of Cypriote GDP) in Greek bank and sovereign debt. Moreover, 40% of loans of the three largest banks are extended to Greece. The recently concluded deal by the euro zone ministers will surely result in sizeable losses on the Greek sovereign exposure of Cypriot banks. Meanwhile, the economic hardship in Greece is also likely to lead to losses on the corporate exposures in Greece. It is not only the asset side through which the banking sector is vulnerable, as the deposit basis of the banks may also be hit. It is likely that the banking sector will soon need to be recapitalized. However, it is doubtful whether the government may be able to provide the necessary capital. According to Fitch, the government faces EUR 1.1bn in financing requirements in the last five months of 2011, against cash balances of EUR 570bn. Moreover, due to the small economic size of Cyprus, the market for Cypriot debt is rather illiquid. In early 2012 a relatively high share of the government debt will mature. Therefore, Cyprus may soon become the fourth country within the euro zone that needs a rescue package. The country thereby faces the challenge of fundamentally changing its business model. In the pre-crisis years large current account deficits (which peaked at 16.9% of GDP in 2008) testified that the country lived beyond its means (see also chart 2). Profits from the large banking sector thereby helped to fund an expensive public sector. Allegedly, Russian oligarchs and Arab dictators have brought billions to the island and the island has a reputation for being relatively lax when it comes to combating money laundering. However, aid from Europe may come with conditions that may make Cyprus less attractive as an offshore financial sector. Moreover, there might be also downsizing pressures on the banking sector, as the crisis has shown the dangers of having such a relatively large banking sector. Overall, Cyprus finds itself in a difficult situation and suffers from a relatively high level of country risk.



Country update CYPRUS

Cyprus						
Selection of economic indicators	2006	2007	2008	2009	2010e	2011f
<i>Key country risk indicators</i>						
GDP (% real change pa)	4.1	5.1	3.6	-1.7	1.0	0.0
Consumer prices (average % change pa)	2.5	2.4	4.7	0.4	2.4	3.1
Current account balance (% of GDP)	-7.1	-8.4	-16.9	-7.4	-5.7	-7.6
Total foreign exchange reserves (mln USD)	5647	6119	617	796	1324	1390
<i>Economic growth</i>						
GDP (% real change pa)	4.1	5.1	3.6	-1.7	1.0	0.0
Gross fixed investment (% real change pa)	10.2	13.4	6.0	-9.1	-7.9	0.5
Private consumption (real % change pa)	4.7	9.4	7.1	-2.9	0.8	0.4
Government consumption (% real change pa)	7.3	0.3	6.2	5.8	0.5	0.5
Exports of G&S (% real change pa)	3.5	6.1	-0.4	-11.3	0.6	1.6
Imports of G&S (% real change pa)	6.7	13.3	8.1	-19.3	3.1	3.0
<i>Economic policy</i>						
Budget balance (% of GDP)	-1.2	3.4	0.9	-6.0	-5.3	-4.8
Public debt (% of GDP)	65	58	48	58	61	64
Money market interest rate (%)	2.9	4.0	4.6	1.2	0.8	1.4
M2 growth (% change pa)	13	19	20	-3	3	3
Consumer prices (average % change pa)	2.5	2.4	4.7	0.4	2.4	3.1
Exchange rate LCU to USD (average)	0.8	0.7	0.7	0.7	0.8	0.7
Recorded unemployment (%)	4.5	3.9	3.6	4.3	4.6	5.0
<i>Balance of payments (mln USD)</i>						
Current account balance	-1279	-1831	-4289	-1745	-1321	-1870
Trade balance	-4942	-6474	-8929	-6022	-5777	-7010
Export value of goods	1393	1483	2371	2137	2791	3170
Import value of goods	6335	7957	11300	8159	8568	10180
Services balance	4221	5039	7045	5821	5658	6510
Income balance	-765	-383	-2297	-1261	-924	-1080
Transfer balance	206	-14	-108	-284	-279	-300
Net direct investment flows	976	1032	-134	590	-1000	1100
Net portfolio investment flows	-149	-497	-17742	-16687	-3026	-2850
Net debt flows	4702	3068	4215	1497	1977	2420
Other capital flows (negative is flight)	-2737	-1208	12446	16301	3400	1260
Change in international reserves	1513	565	-5505	-44	30	60
<i>External position (mln USD)</i>						
Total foreign debt	22132	27080	32622	31421	32795	34470
Short-term debt	7248	9150	10761	10835	11300	12050
Total debt service due, incl. short-term debt	4110	8211	10815	12293	12516	13000
Total foreign exchange reserves	5647	6119	617	796	1324	1390
International investment position	7279	2892	969	8323	n.a.	n.a.
Total assets	71367	91976	110830	145017	n.a.	n.a.
Total liabilities	64088	89084	109861	136694	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>						
Trade balance (% of GDP)	-27.3	-29.8	-35.1	-25.5	-25.0	-28.3
Current account balance (% of GDP)	-7.1	-8.4	-16.9	-7.4	-5.7	-7.6
Inward FDI (% of GDP)	10.3	10.6	15.3	24.8	8.6	8.5
Foreign debt (% of GDP)	122	125	128	133	142	139
Foreign debt (% of XGSIT)	192	177	167	190	205	199
International investment position (% of GDP)	40.2	13.3	3.8	35.3	n.a.	n.a.
Debt service ratio (% of XGSIT)	36	54	55	74	78	75
Interest service ratio incl. arrears (% of XGSIT)	3	4	6	8	9	8
FX-reserves import cover (months)	7.3	6.3	0.5	0.8	1.3	1.2
FX-reserves debt service cover (%)	137	75	6	6	11	11
Liquidity ratio	401	367	207	252	200	195

Source: EIU & Rabobank estimates.

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.