EMERGO
WEALTH

Economy & Banking: Cyprus

Key Dynamics & Expectations

Report: Q3 2013

November 2013

Economic Outlook: Cyprus

The near-term outlook - a depression is more likely than a recession…

A decline in real GDP in excess of 9% appears likely for YE2013, with further significant declines in the following years

Structural challenges to the Cypriot economy

Unemployment is increasing. More than 75,000 unemployed (Q3 2013)

New Rules of the Game…

2013-14 is expected to be a recessionary year for the local economy

Cyprus bailout agreement creates an important precedent for future resolution of insolvent banks in the euro area

Banking Sector: Cyprus

Confidence in the banking sector will take time to be restored. Deposits are still declining and restructuring of banks is on-going.

Cyprus banks' access to Eurosystem funding through conventional repo operations is a thing of the past for most of its banks.

The future capital hole in the banks is likely to be bigger than initially thought

NPL management is key

Deposit outflow

Banks need to regain trust of new and existing customers

Overview: Key Economic Indicators

The economic outlook for Cyprus remains bleak despite growth so far in 2013 performing better than analysts (Moody's and Fitch) previous expectations. Various analysts currently expect that GDP to contract 7% in 2013 compared with previous forecast of nearly 9% and after declining 2.4% in 2012. The economy is likely to remain in deep recession in 2014 with the downturn lasting longer than assumed under the EU-IMF programme.

Initial record of implementation under the EU-IMF programme has been good, with fiscal outperformance relative to targets in 2013. Nevertheless, there remains a high risk of the multi-year programme going off track due to downside risks to economic performance and/or a weakening in political commitment to the programme.

Analysts continue to expect gross general government debt/GDP to peak slightly above 130% of GDP in 2016. In Fitch baseline projections, they expect debt ratio to fall only gradually in the second half of the decade, owing to some slippage from ambitious fiscal targets in the medium term and weaker growth. Public finances could therefore remain vulnerable to shocks well beyond the programme period which is scheduled to end in 2016.

Table 1: Key Economic Indicators

Indicator	2010	2011	2012	2013 Q3 (est.)
GDP (Real_%)	1.1	0.6	-3.1	-6.2
HCPI (%)	2.5	3.5	3.1	2.1
Unemployment (%)	6.4	7.8	14.7	18-19
Fiscal Balance (%_GDP)	-5.4	-6.3	-4.9	-5.0
Public Debt (%_GDP)	60.7	71.7	85	105
Current Account Bal. (%_GDP)	-7.8	-10.5	-6.7	-2.1

Sources: IMF (2013), Cyprus National Statistics (2013), CBC (2013), Moodys (2012), Fitch (2013), Emergo Wealth (2013)

Confidence in the banking sector will take time to be restored. Deposits are still declining and restructuring of banks is on-going. Banking sector recapitalisation has progressed and analysts do not expect any additional public funds to be used to support the banking sector beyond the €1.5bn budgeted for capitalisation of cooperatives and the €1bn buffer in the EU-IMF programme.

Restrictions on bank transfers are being gradually lifted. However, the process of lifting capital controls carries risks, and a premature exit could trigger material capital flight.

However, there are some initial signs of positive economic adjustments. Growth in employee compensation has fallen below growth in productivity, leading to an improvement in labour costs. The current account deficit has narrowed to c.2% of GDP in 2013 from over 6% in 2012, reflecting a contraction in domestic demand and imports.

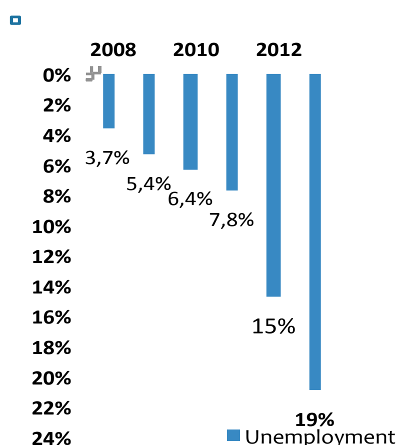
The one-notch differential between the local currency IDR (CCC) and the foreign currency IDR (B-) reflects Fitch's assessment of the greater vulnerability of bonds issued under domestic law relative to foreign-law bonds, as demonstrated by the 2013 restructuring of domestic law bonds, which revealed a preferential treatment of foreign-law sovereign bonds.

Deteriorating Outlook: Unemployment

As the financial crisis deepens, new September figures show that over 76,000 are now unemployed in Cyprus, with the figure set to rise as the tourist attractions 'close for the winter'. Eurostat (2013) indicates that unemployment in Cyprus recorded a new high in September 2013, reaching 17.1% or 76,000 persons compared to 16.9% or 75,000 persons in August 2013.

At the same time Cyprus recorded the highest increase among EU member states since September 2012, from 12.7% or 56,ooo persons to 17.1% or 76,000, which is the third highest percentage in EU following Greece's 27.6% (July 2013) and Spain's 26.6%.

Figure 1: High Real Unemployment



Source: Eurostat (2013)

Cyprus Risk Factors

The negative outlook of Cyprus reflects the following risk factors:

1. Significant slippage from the programme targets, in particular fiscal deficits, or adverse changes to public debt dynamics (for instance, caused by a deeper-than-expected recession or political instability)
2. A recession that is materially deeper or longer lasting than assumed by Troika and analysts which would have adverse consequences for the public debt dynamics
3. Intensification of the banking crisis in Cyprus, (i.e. capital flight from banks if capital controls are lifted prematurely)
4. A further restructuring of Cyprus's marketable liabilities judged by analysts as distressed debt exchange

Future developments that may, individually or collectively, lead to the Cyprus outlook being revised to stable include:

1. A longer track record of successful implementation of the EU-IMF programme and signs of a stabilisation in the economic output and the banking sector
2. Improvements in export performance that help facilitate the rebalancing of the economy
3. Lifting of capital controls with no material negative economic consequences. Exit from capital controls would also lead to an upgrade from major analysts

The main capital restrictions remain. Bank-to-bank transfers are allowed without restriction for amounts up to €15,000 for individuals and up to €75,000 for companies. For the purchase of goods and services companies may transfer €300,000 within Cyprus. Companies may transfer up to €500,000 abroad for "normal business activity" with the approval of the bank branch; from €500,001 to €1mn on the basis of a pre-approved list; and over €1mn with the approval of a committee.

The Program: Risks & Measures

Analysts currently assume that the fiscal costs of bank recapitalisation will not exceed the €2.5bn specified under the EU-IMF programme, which includes a contingency buffer of €1bn. The banking sector has been recapitalised, including via the conversion of uninsured deposits in the island's largest lender, the Bank of Cyprus.

Official EU/IMF funding will only be used to recapitalise the cooperatives, with €1.5bn secured in a special account. Hellenic Bank is now the island's second largest lender after Cyprus Popular Bank was put under special administration and recently completed its recapitalisation privately. The capital needs of the banking sector were estimated under very conservative assumptions under the Pimco assessment of the sector earlier this year.

Most analysts do not factor possible hydrocarbon receipts into their projections; these therefore represent an upside factor beyond the near term. While the authorities claim government revenues to range between €18.5bn (102.9% of GDP) to €29.5bn (164.1% of GDP) in drilling block 12 off the southern coast of Cyprus alone, the economic viability of extraction remains uncertain and beyond the horizon of the programme.

Fitch (2013) assumes there will be progress in deepening fiscal and financial integration at the eurozone level in line with commitments by policy makers. It also assumes that the risk of fragmentation of the eurozone remains low, and that Cyprus remains a member of the eurozone. The authorities' program focuses on two key objectives aimed at achieving sustainable growth:

- Restoring financial sector stability: The authorities' policy actions aim to place the banking system on a sustainable footing so as to restore financial intermediation and support economic activity.
- Achieving sustainable public finances: The program entails an ambitious and well-paced fiscal adjustment that balances short-run cyclical concerns and long-run sustainability objectives, while protecting vulnerable groups. Structural fiscal reforms will support these efforts, with privatisation and reforms.

Debt Dynamics

Given substantial downside risks to the outlook, full implementation of the program is essential to achieve sustainable debt dynamics. The debt-to-GDP ratio is expected to peak at 130 percent in 2016, given continued fiscal deficits and weak growth. Thereafter, debt dynamics are expected to improve as growth resumes and the primary surplus improves.

With full implementation of policies under the program, the debt ratio is projected to continue to fall, reaching around 105 percent of GDP by 2020.

While these dynamics could be considered sustainable in the baseline scenario, macroeconomic risks are unusually high, and a worse-than-expected macroeconomic outlook or implementation slippages would have profound adverse implications for the debt trajectory. Should these risks materialise, additional financing measures may be needed to preserve debt sustainability (IMF, 2013).

The 2013 budget and supporting legislation passed include consolidation measures estimated at about 5-8 percent of GDP for 2013-2016.

These include scaled public sector wage cuts of 10-15 percent, rationalisation of social benefits and
pensions, and increases in the VAT, excise taxes, social security contributions and privatisations.

Given this and the expected deep downturn, the mission advised to:

- limit additional fiscal measures beyond those already in train;
- provide more time to reach the authorities' long-term primary balance target of 4 percent of GDP; but
- be ready to identify and implement at a later time additional measures taking effect during 2015-2018 required to reach the long-term target. The authorities concurred with the need to balance cyclical considerations and sustainability concerns.

The pace of fiscal consolidation is comparable to that in other European programs (IMF, 2013).

Banks' loan quality continue to deteriorate

Credit to the economy continued to contract

Official statistics indicate that non-performing loans (NPLs) reached 30% of total loans in April 2013 (NPLs will be significantly higher in October - PIMCO's and KPMG's reports assuming SME non-performing loans rising to 57% and 45% respectively for 2013). Also, provisioning for loan losses stands at only 30% of total loans, well below the average ratio of 50% for EU banks. This suggests that Cypriot banks' profitability will be significantly affected going forward. As expected following the March crisis, credit supply has contracted in the face of rapidly deteriorating loan quality and tight liquidity. As a result, corporate credit contracted by 9% YoY in June, with mortgage lending and consumer credit falling by about 3-7%, respectively. To this end, to increase transparency, a new CBC directive will enter into force at the end-September, requiring reporting and classification of all loans in arrears for more than 90 days as NPLs, and all loans whose original terms were modified! This is expected to lead to significantly higher officially reported NPLs than the ones currently offering (YE13 > 45% average NPL rate for the Cypriot banking system). Also, the CBC agreed to put in place a new regulatory framework on loan origination, requiring banks to consider affordability aspects in their lending decisions.

Importantly, new steps were agreed to facilitate corporate and household debt restructuring to address the high level of private indebtedness. Given the large number of existing and prospective loans in need of restructuring, IMF stressed the need for swift improvement in Cyprus's private debt restructuring framework with a view to facilitate a reduction in NPLs and in private sector indebtedness. The Cypriot private sector is currently highly leveraged. The current private sector debt-to-GDP ratio is close to 280 %, which is the highest in Europe and about double of the EU average. Corporate credit has been concentrated in the real estate and construction sectors. For households, housing loans account for more than half of the total, leading to a high exposure of banks to the decline in house prices that began in 2009.

Confidence in the banking sector is yet to be restored. The extent of the impact of the banking crisis on households and corporates, as well as on vital service sectors of the economy, will be larger than anticipated. These could result in a deeper and more prolonged recession, as well as in weaker long-run growth, with dramatic consequences for debt sustainability (IMF, 2013). On the external front, continued economic weakness in the EU could dampen demand for Cypriot exports. On the upside, tourism service exports could benefit from political turmoil in competing destinations and stronger non-EU demand (e.g. China and Russia). Development of the gas sector could also provide an upside to investment and growth over the longer term.

MoU: Revised terms | November | 2013

Repossessions: The social stabling block

According to the revised MoU (November 2013), strong efforts should be made to maximise bank recovery rates for non-performing loans, while minimising the incentives for strategic defaults by borrowers. The administrative hurdles and the legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized within a maximum time-span of 1.5 years from the initiation of legal or administrative proceedings. In the case of primary residences, this time-span could be extended to 2.5 years.

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