# Sapienta Country Analysis

## Cyprus

January 2013

*Comprehensive monthly analysis of politics, economic policy and the economy*

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# Overview Jump to next section

*25 January 2013*

- Since our December report the leader of the opposition, right-wing Democratic Rally (DISY), Nicos Anastassiades, has extended his the lead in the polls for the presidential election on 17 February 2013 and we continue to put his chances of becoming president at 70%. There remains a very small chance that George Lillikas could win in the second round if he can take enough voters from the Democratic Party (DIKO), who tend to be more ideologically aligned with Mr Lillikas on the Cyprus problem.

- Almost all of the measures required by the troika for the bailout have already been passed with either unanimous or near unanimous backing. But there is a significant risk that the bailout will not be ratified by German opposition politicians, who have serious reservations about assisting Cyprus because of perceptions about money-laundering. We expect a strong gesture from both Cyprus and Russia will be demanded before a bailout will be approved. Without a bailout, Cyprus would default on 3 June when a large debt payment falls due.

- On the basis of January-November figures the primary deficit appears to have been cut in half in 2012, which could have a positive impact on debt sustainability. A €150m boost to the 2013 budget came from the signature of natural gas licences with ENI and KOGAS for three blocks on 24 January. Under our own projections, if bank recapitalization needs amount to €10bn then the debt/GDP ratio would rise to 135.8% of GDP by 2016. However, it would need to be cut by only €3bn to bring it down to a more sustainable 120% of GDP by 2016.

- We estimate that a haircut on bonds (if it could be implemented, which is questionable), could reduce debt by €1.3bn, while privatization could reduce debt by €2bn. Another option is to extend maturities until natural gas revenues flow in (which we do not expect for 15 years) or to borrow in three years' time on the basis of the net present value (NPV) of gas, which we estimate at €6bn. Israel's experience suggests that monetizing the NPV to the full extent will depend among other things on having the full regulatory framework in place.

- Owing to the continued uncertainty surrounding the bailout, we now expect a steeper real GDP contraction of 3.0% in 2013. Latest quarterly indicators indicate continued recession. Real estate sales dropped by 33% in the third quarter of 2012, tourism arrivals fell in the fourth and unemployment hit a new high of 14% in November. Economic contraction and high unemployment pushed the inflation rate down to 1.8% in the fourth quarter.

**Table 1**

**Macroeconomic forecast**

| | 2011 | *2012* | *2013* | *2014* | *2015* | *2016* |
|---|---|---|---|---|---|---|
| GDP at current prices € m | 17,979 | *18,139* | *17,891* | *18,347* | *18,901* | *19,568* |
| Real GDP growth % | 0.5 | *-2.1* | *-3.0* | *0.3* | *1.0* | *1.5* |
| Harmonized consumer price inflation % | 3.5 | 3.1 | 1.6 | 2.2 | 2.0 | 2.0 |
| Unemployment rate (%) | 7.6 | *12.0* | *14.3* | *13.6* | *12.4* | *10.8* |
| Budget balance (Maastricht ESA95 definition) € m | -1,132 | *-1,050* | *-850* | *-800* | *-750* | *-700* |
| % of GDP | -6.3 | *-5.8* | *-4.8* | *-4.4* | *-4.0* | *-3.6* |
| Primary balance € m | -706 | *-350* | *-98* | *-1* | *116* | *284* |
| % of GDP | -3.9 | *-1.9* | *-0.5* | *0.0* | *0.6* | *1.5* |
| Gross public debt excluding direct bank recap € m | 12,777 | 15,316 | *18,021* | *21,921* | *24,871* | *26,571* |
| % of GDP | 71.1 | *84.4* | *100.7* | *119.5* | *131.6* | *135.8* |

Sources: Cystat, Ministry of Finance, Sapienta Economics estimates and forecasts in italics.

## Political analysis and forecast Jump to next section Revert to previous section

### Anastassiades increases his lead in the presidential election polls

Since our December report the leader of the opposition, right-wing Democratic Rally (DISY), Nicos Anastassiades, has extended his lead in the polls for the presidential election due on 17 and 24 February 2013, with an average lead over his main rival in the first round of 16.3 percentage points (see Table 2). We therefore continue to put his chances of becoming president at 70%. Mr Anastassiades has benefited from disappointment with the current president, Demetris Christofias, who hails from the ruling communist Progressive Party of Working People (AKEL), and AKEL's handling of the fiscal and banking crisis. Mr Anastassiades is also supported by the third largest party, the Democratic Party (DIKO), which took 15.8% of the vote in the 2011 parliamentary election and typically plays a critical role in deciding the president. Despite disappointment with the current government, AKEL's candidate, Stavros Malas (who is not a traditional AKEL member), has improved his ratings and is now second, ahead of George Lillikas, a former minister who has no particular party affiliation, having run as an AKEL member of parliament, served as minister under the DIKO presidency of the late Tassos Papadopoulos, and is now being supported by the Social Democratic Party (EDEK), which took 8.9% of the vote in 2011. There are 11 candidates in total.

Although Mr Lillikas is third in the polls, there remains a small chance that he could win in a second-round run-off against Mr Anastassiades if he can take enough of the still large undecided votes, especially from DIKO. DIKO voters tend to take a hard line on the decades-old Cyprus problem and are therefore more ideologically aligned with Mr Lillikas, who masterminded the campaign against the 2004 referendum on the so-called Annan Plan to reunite the island, than Mr Anastassiades, who supported it. Mr Lillikas already has the support of Nicos Papadopoulos, the son of the late Tassos Papadopoulos and former deputy leader of DIKO, who resigned this position on 17 January in order to support Mr Lillikas. As stated in our December report, the risk of a Lillikas win would be higher if the Cyprus problem had been a main feature of the election, but for the first time in the Republic of Cyprus' history, the Cyprus problem has been overshadowed by the economic crisis.

**Table 2**

| Polls on voting intentions | Mega/ UNIC | CyBC/ CMR | Simerini/ Pulse | *Average of the three* |
|---|---|---|---|---|
| | 22-Jan | 18-Jan | 01-Jan | |
| **First round** | | | | |
| Nicos Anastassiades (DISY) | 38.3 | 38.0 | 36.7 | 37.7 |
| George Lillikas (independent) | 19.7 | 20.4 | 20.5 | 20.2 |
| Stavros Malas (AKEL) | 21.8 | 23.7 | 18.5 | 21.3 |
| Others/undecided/no answer | 20.2 | 17.9 | 24.3 | 20.8 |
| Anastassiades lead over Malas | 16.5 | 14.3 | 18.2 | 16.3 |
| **Second round: Anastassiades v. Lillikas** | | | | |
| Nicos Anastassiades | 43.2 | 41.1 | 41.0 | 41.8 |
| George Lillikas | 31.4 | 31.8 | 33.0 | 32.1 |
| Anastassiades lead over Lillikas | 11.8 | 9.3 | 8.0 | 9.7 |
| Undecided/no answer | 25.4 | 27.1 | 26.0 | 26.2 |
| **Second round: Anastassiades v. Malas** | | | | |
| Nicos Anastassiades | 49.5 | 43.8 | 48.0 | 47.1 |
| Stavros Malas | 25.3 | 29.9 | 26.0 | 27.1 |
| Anastassiades lead over Malas | 24.2 | 13.9 | 22.0 | 20.0 |
| Undecided/no answer | 25.2 | 26.3 | 26.0 | 25.8 |

Source: Newspaper reports.

A win by Mr Lillikas would increase already high uncertainty about a bailout, since he has claimed that Cyprus can avoid borrowing from the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) —the "troika"—by raising funds on the basis of future natural gas revenue. However, we believe that raising funds before the gas is actually exported will not be a viable option for two to three years (see below).

**Mr Anastassiades' first task will be to persuade Germany**

Mr Anastassiades' immediate task will be to sign the memorandum of understanding (MoU) on the bailout. Almost all of the laws required in the draft MoU have already been passed, either unanimously or with only one or two objections, therefore he will have the strong backing of parliament for whatever additional measures might be demanded. A more difficult task will be to persuade German opposition politicians in the upper and lower houses of the parliament that Cyprus is properly implementing laws to tackle money-laundering. This is likely to require some significant and possibly painful gestures (see below). The main domestic challenge in the coming years will be dealing with unemployment, which has shot up in recent years. Youth unemployment has surpassed 25% but for the time being this has not led to the kind of social unrest seen in Greece. However, early signs that this could change are that the nationalist ELAM party has fielded a candidate for the first time (currently with around 2% support), as well as the odd incidence of violence when ELAM has clashed on the street with AKEL's youth movement.

**The Cyprus problem will take a low priority**

While the economic crisis takes centre stage, we expect attempts to resolve the Cyprus problem to be low priority. Negotiations with the Turkish Cypriots have been *de facto* suspended since March 2012. While we expect negotiations to be revived once the new president takes power, there is unlikely to be much progress for the time being. This means that Turkey will continue to make protests about offshore oil and gas exploration and may take measures to make exploration more difficult for companies involved in exploration and exploitation.

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**Primary deficit appears to have been cut in half in 2012—**

The primary deficit (budget balance minus interest payments) shrank to €155m (cash basis) in January-November 2012 from €315m in the same period of 2011 (See Table 3). On the basis of the relationship between the primary deficit in the first 11 months of 2011 and the whole of that year, we estimate that the primary deficit (Maastricht ESA95 basis) was cut in half to 1.9% of GDP in 2012. A small boost to the 2013 budget also came on 24 January when the government received a signature bonus of €150m (enough to pay one month of civil servant salaries) for natural gas licence agreements with the consortium comprising ENI of Italy and KOGAS of South Korea for Blocks 2, 3 and 9 in the Cyprus Exclusive Economic Zone (EEZ). A signature with Total for Blocks 10 and 11 is expected in the coming weeks.

Despite progress on the primary deficit, the breakdown of figures shows how rising unemployment and higher interest payments on new debt have hampered the government's efforts to bring down the overall budget deficit. Social security expenditure, which is the third highest expenditure item, rose over the year earlier by 10.4% in January-November to €1.3bn as unemployment soared, while social security receipts fell by 3.7% to €920m owing to a decline in employment. As the government was forced to pay higher interest rates on short-term domestic debt, interest payments rose by 15.4% in the same period to €589m. We estimate that the overall budget deficit (ESA95 definition) reached 5.8% of GDP in 2012.

**Table 3**

| **Consolidated central government & administered funds**<br>€ '000; cash basis (not Maastricht ESA95 basis) | | | | |
|---|---|---|---|---|
| | **2011 Year** | **2011 Jan-Nov** | **2012 Jan-Nov** | **% change** |
| Direct taxation | 2,058,218 | 1,709,702 | 1,755,350 | 2.7 |
| Income tax | 1,446,452 | 1,184,590 | 1,160,295 | -2.1 |
| Indirect taxation | 2,502,049 | 2,241,956 | 2,270,501 | 1.3 |
| VAT | 1,509,295 | 1,338,087 | 1,355,190 | 1.3 |
| Social security contributions | 1,047,888 | 955,504 | 920,498 | -3.7 |
| Non-tax revenue | 855,756 | 701,513 | 659,701 | -6.0 |
| Capital revenue | 0 | 0 | 0 | 0.0 |
| Foreign grants | 125,620 | 97,121 | 71,943 | -25.9 |
| **Total revenue & grants** | **6,589,531** | **5,705,795** | **5,677,994** | **-0.5** |
| Current expenditure | 7,135,257 | 6,132,874 | 6,142,440 | 0.2 |
| Wages & salaries | 1,947,811 | 1,666,353 | 1,645,815 | -1.2 |
| Other goods & services | 543,552 | 448,815 | 432,067 | -3.7 |
| Subsidies | 87,673 | 62,163 | 85,181 | 37.0 |
| Interest payments | 535,319 | 511,830 | 589,012 | 15.1 |
| Social security payments | 1,367,881 | 1,163,675 | 1,285,297 | 10.5 |
| Pensions & gratuities | 549,345 | 470,044 | 550,900 | 17.2 |
| Social pension | 62,594 | 53,067 | 54,575 | 2.8 |
| Other current transfers | 1,944,355 | 1,664,900 | 1,431,330 | -14.0 |
| Unallocable (mainly defence) | 96,727 | 92,027 | 68,263 | -25.8 |
| Capital expenditure | 538,853 | 400,250 | 279,849 | -30.1 |
| Net lending | 0 | 0 | 0 | 0.0 |
| **Total expenditure & net lending** | **7,674,110** | **6,533,124** | **6,422,289** | **-1.7** |
| | | | | |
| **Primary balance (excluding interest payments)** | **-549,260** | **-315,499** | **-155,283** | **-50.8** |
| % of GDP (Sapienta estimate, inferred from total balance) | -3.0 | -1.8 | -0.9 | - |
| **Overall budget balance** | **-1,084,579** | **-827,329** | **-744,295** | **-10.0** |
| % of GDP (as reported) | -6.0 | -4.6 | -4.2 | - |

Source: Ministry of Finance.

### —with potentially positive implications for debt sustainability

A sharp fall in the primary deficit could have important implications for debt sustainability after Cyprus receives financial assistance from the troika. The IMF in particular has been concerned that the level of debt could be so high that the government will not be able to pay it back. The question turns mainly on how much recapitalization will be needed by Cyprus Popular Bank (CPB) and Bank of Cyprus (BOC), the two largest banks which suffered more than €4bn in losses after the write-off in 2012 of around 75% of Greek government debt. The initial estimate by Pimco, the firm hired to calculate the bank recapitalization requirements, was €10bn. At the time of writing its final estimate was still awaited. The government will also need to borrow €8bn to fund maturing debt in 2013-16 (including the €2.5bn Russian loan), although since this is not new debt it will not add to debt stock. Assistance from the troika could therefore amount to €18bn (100% of GDP).

**Table 4**

| Estimated bailout requirements<br>€ m unless otherwise indicated | | | | | | |
|---|---|---|---|---|---|---|
| | **2012** | **2013** | **2014** | **2015** | **2016** | **Total** |
| Known recapitalization requirement | 1,888 | 1,855 | - | - | - | 3,743 |
| CPB requirement inc. June 2012 bailout | 1,888 | 1,125 | - | - | - | 3,013 |
| BOC requirement | - | 730 | - | - | - | 730 |
| Possible additional bank requirement | 0 | 0 | 3,100 | 2,200 | 1,000 | 6,300 |
| **Total possible bank recapitalization** | **1,888** | **1,855** | **3,100** | **2,200** | **1,000** | **10,043** |
| Maturing debt exc. Jun 2012 bailout but inc. Russian loan | 307 | 2,140 | 964 | 1,312 | 3,231 | 7,954 |
| **Total troika requirement exc. budget deficits** | **2,195** | **3,995** | **4,064** | **3,512** | **4,231** | **17,997** |
| Debt level with no direct ESM recapitalization | 15,316 | 18,021 | 21,921 | 24,871 | 26,571 | - |
| **Debt/GDP ratio with no direct ESM recapitalization (%)** | **84.4** | **100.7** | **119.5** | **131.6** | **135.8** | **-** |
| Debt level with direct ESM recapitalization | 15,316 | 16,166 | 16,883 | 17,431 | 17,833 | - |
| **Debt/GDP ratio with direct ESM recapitalization (%)** | **84.4** | **90.4** | **92.0** | **92.2** | **91.1** | **-** |
| **Memorandum item** | | | | | | |
| Government debt/GDP ratio forecast | 85.8 | 92.0 | 95.6 | 95.0 | n/a | - |

Sources: EBA, Ministry of Finance, Sapienta Economics debt, deficit and interest forecasts.

The debt stock in 2012 reached €15.3bn (an estimated 84.4% of GDP) according to preliminary figures. Under our own projections (see Table 4) the debt/GDP ratio could surpass 135% of GDP by 2016. However, it would need to be cut by only €3bn to bring it to a more sustainable 120% of GDP. Since privatization could fetch €2bn (see below), this explains why the government and the Central Bank of Cyprus have been calling into question Pimco's methodology in an attempt to cut the figure to €9bn or less. Our own judgement is that €10bn is a reasonable assumption, given that BOC and CPB have €22bn of private-sector loans in Greece, €26bn in Cyprus and rapidly increasing non-performing ratios (see Table 5).

**Table 5**

| Private-sector loans and deposits in Greece, Sep 2012<br>€ m unless otherwise indicated | | | |
|---|---|---|---|
| | **Cyprus** | **Greece** | **Group** |
| **Gross loans** | | | |
| Bank of Cyprus | 14,883 | 9,472 | 28,226 |
| Cyprus Popular Bank | 11,100 | 12,200 | 25,592 |
| Hellenic Bank | 4,659 | 937 | 5,596 |
| **Total three banks** | **30,642** | **22,609** | **59,413** |
| **Provisions for impairment of advances** | | | |
| Bank of Cyprus | - | - | 2,249 |
| Cyprus Popular Bank | - | - | 3,173 |
| Hellenic Bank | - | - | 773 |
| **Total three banks** | **-** | **-** | **6,196** |
| **Deposits** | | | |
| Bank of Cyprus | 18,511 | 6,511 | 27,873 |
| Cyprus Popular Bank | 10,251 | 6,032 | 17,865 |
| Hellenic Bank | 7,086 | 599 | 7,667 |
| **Total three banks** | **35,848** | **13,142** | **53,405** |
| **Non-performing loan ratio (%)** | | | |
| Bank of Cyprus | 15.8 | 20.9 | 17.1 |
| Cyprus Popular Bank | 17.2 | 40.1 | 27.4 |
| Hellenic Bank | n/a | n/a | 17.7 |

Source: Q3 financial statements and investor presentations.

## Various options for debt sustainability are considered

If the banks were able to borrow directly from the European Support Mechanism (ESM), the debt/GDP ratio would remain below 100% of GDP. President Christofias sent a letter to the European Commission President, Jose Manuel Barroso, on 11 January asking that the banks' capital shortfall should be funded directly by the ESM. However, until further progress is made in establishing a eurozone banking union, it seems unlikely that this will be approved by eurozone leaders. Moreover, it remains open to question whether direct bank recapitalization will ever be allowed retrospectively. Whatever the final recapitalization figure, therefore, it seems that the troika will insist on additional measures to ensure that the debt will be sustainable. The media have focused on three main options: what has been termed a haircut on deposits, a haircut on bonds similar to that implemented in Greece, and privatization.

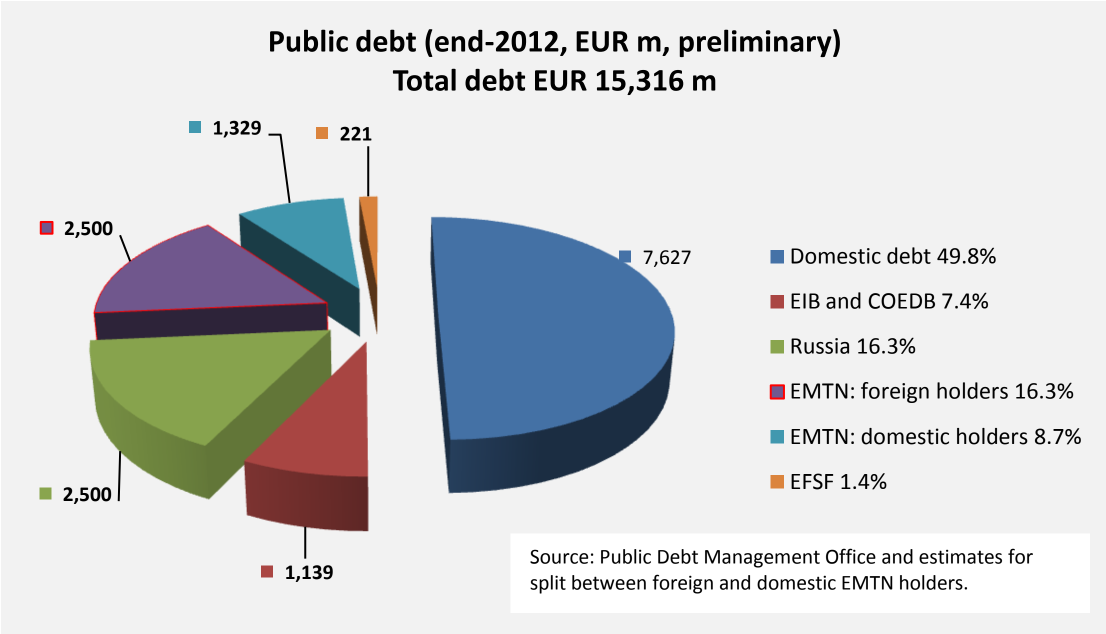
As regards a haircut on deposits, the general idea is to tap into uninsured deposits (those over €100,000), largely in order to target Russian depositors and therefore satisfy popular demand that Russians must be seen to pay for the bailout (see below). However, it is difficult to envisage how this could be implemented in legal or practical terms and without a collapse of the banking system as confidence evaporated. Moreover, hitting depositors could lead to an even higher bill for the government (and therefore the troika), since the government's net contingent liability for the insured deposits under €100,000 was €35.3bn at the end of 2011 according to official sources. Our sources suggest that there is in fact little appetite for this option in European circles, therefore it may be that this option is being mooted in order to persuade the government to agree to less drastic measures such as privatization. While Mr Anastassiades has said ahead of the election that he will avoid privatization if possible, his party is not ideologically opposed to it as the current government is and we believe that he will pursue it if there is no other option.

**We estimate privatization could fetch €2bn**

The Electricity Authority of Cyprus (EAC), the dominant electricity provider, is the most attractive target. According to EMS Economic Management citing a report of the auditor-general, EAC had assets of €2.2bn and annual revenue of €926m in 2011. The other two main targets are the Cyprus Telecommunications Authority (CYTA), the dominant telecoms provider, with revenue of €526m and a quoted reserve value of €875m, and the Cyprus Ports Authority which is also said to hold a substantial amount of property. While some estimates have suggested that privatization proceeds could reach €10bn, we believe that the combination of likely union resistance to cutting generous salaries and benefits, high pension liabilities and a very weak property market mean that privatization would raise €2bn. This amount would still go a long way towards addressing debt sustainability, especially if the bank recapitalization needs come in at €9bn.

The third option being mooted, namely a haircut on holders of Cyprus debt, would probably not raise as much as privatization and could result in a higher recapitalization requirement for the banks. Of the outstanding debt of €15.3bn according to preliminary figures at the end of 2012 (see chart), most of it is either domestic debt held by the very banks that need recapitalizing, or senior loans from institutions like the European Investment Bank (EIB) and the Council of Europe Development Bank (COEDB), for which eurozone leaders are unlikely to accept any write-offs. Only the €3.8bn in European Medium Term Notes (EMTN) would be a genuine target for a haircut. Inferring from official reports, we estimate that €2.1bn of the EMTN is held by domestic banks, so effectively the haircut would be implemented on only €1.7bn. If the haircut were 75%, as in Greece, then this would reduce the debt stock by a mere €1.3bn. Moreover, the legal terms of these notes issued under English law may mean that a haircut on this debt would trigger default clauses and perhaps create more problems than it would solve.




**Government could monetize NPV of natural gas in around three years**

On balance, it seems likely that the troika will opt for insisting on privatization and perhaps the fourth option, namely extending maturities. This would give the budget time to shift into primary surplus (currently forecast by the government for 2014), which would lead to a gradual reduction of the debt stock once borrowing for recapitalization had ended. Longer maturities would also give the government time to monetize the offshore natural gas finds. We believe that gas will not actually be exported for 15 years—rather longer than the government's estimate of a liquefied natural gas (LNG) plant by 2018. This is because factors such as economies of scale, Cyprus' credit rating and uncertainties about future gas prices mean that Cyprus is unlikely to find financing for an LNG plant that will cost around $10bn (€7.5bn), or some 40% of GDP, until it has secured larger gas volumes and a long-term buyer. After financing is secured, it typically takes ten years to build a plant, especially when there is government involvement.

However, the government could borrow on the basis of the net present value (NPV) of the gas even before the gas is exported. Taking the estimated 7 trillion cubic feet (tcf) in Block 12 of the EEZ—which it should be emphasized has not yet been proven—current spot prices for LNG in Europe of around $11 per million British thermal units (MMBTU), and after deducting around 25% for domestic consumption and the use of gas to produce LNG, then infrastructure and exploration costs and the profit margin to the oil and gas companies, we estimate that the revenue flowing to the government could be nearly $2bn (€1.5bn) per year over 25 years (a typical supply period). With an assumed 8% cost of capital, this translates into an NPV of around $8bn (€6bn). The recent sale of a 30% stake in Israel's Leviathan block of 19 tcf for only $2.5bn (contingent on certain developments) suggests that monetizing this to the full extent will depend on the regulatory framework being properly in place, the reserves having been proven and a full commitment by the government to export (which is still lacking in Israel). The appraisal well that will establish the proven reserves for the Cyprus Block 12 find has now reportedly been pushed back until the second half of the year and the licences from the second bidding round have only just started to be awarded. Therefore, we believe that establishing the correct conditions for monetizing the gas could take two to three years. This also bolsters the argument for longer maturities.

**Significant risk of default if Germany's parliament will not ratify**

As anticipated in our December report, the Eurogroup meeting of eurozone finance ministers confirmed on 21 January that Cyprus will not receive financial assistance under the ESM before the presidential election on 17 and 24 February. Even if a satisfactory solution to debt sustainability is found, there remains another significant risk to the bailout, namely opposition from elected deputies in Germany. While we expect that, if Mr Anastassiades wins the election he will swiftly sign an agreement, there is now a significant risk that it will not be ratified by either the Bundestag, Germany's lower house of parliament, or the Bundesrat, the upper house, which is dominated by opposition parties. Partly because Cyprus conducts a large amount of business with Russian companies and individuals, there is a strong perception in Germany in particular that Cyprus must be a centre for money-laundering. This perception was bolstered by a leaked report from Germany's secret service in *Der Spiegel* magazine in November, which reportedly alleged that rules against money-laundering are not being properly implemented in Cyprus, although we understand that it did not provide any proof to that effect. Prominent German deputies from both the coalition and opposition parties have since suggested that they will not support a bailout. Others have questioned whether Cyprus qualifies for a bailout since it may be too small to present a systemic risk to the eurozone. The Commissioner for Economic and Monetary Affairs, Olli Rehn, among others, has rejected this notion. Moreover, remarks about the need for solidarity made by Germany's Chancellor, Angela Merkel, during her visit to Cyprus in January to support Mr Anastassiades at the conference of the European People's Party (EPP), the biggest grouping in the European Parliament, suggest that she does not share this view. Nevertheless, there are now demands that an expert team be sent to Cyprus to check whether the country is properly implementing these and other laws.

**We expect Cyprus and Russia to have to make large gestures**

We believe that the German parliament will not approve a bailout for Cyprus without a significant gesture from both Russia, in terms of financing, and Cyprus, in terms of tackling money-laundering. Russia has already been asked to extend to 2020 the maturity of the €2.5bn loan lent in late 2011 and early 2012 that matures in 2016. According to Cypriot press reports, it is also being asked to fund half of an IMF contribution that could amount to €4bn. It is not obvious what the gesture from Cyprus should be. Cyprus is already on the OECD White List for tax jurisdictions and, according to a presentation made in January by the Cyprus anti money-laundering unit, MOKAS, it is fully compliant with more of the Financial Action Task Force (FATF) recommendations than ten other eurozone countries including Germany. Cyprus has the lowest threshold in the EU for the identification of beneficial ownership (10%), compared with the 25% threshold provided for in the 3rd EU anti-money-laundering directive. In addition, the 23 legislative amendments passed to meet troika requirements in December included a law on administrative co-operation for the exchange of information between EU member states for the purposes of tax collection.

One target could be an increase in the corporate tax rate, which at a flat rate of 10% is the lowest in the eurozone and has so far been protected from troika measures in recognition of its contribution to employment and growth. Another target could be a demand that Cyprus support the proposed financial transaction tax, which Cyprus opposes partly because of the large amount of corporate transactions that take place through Cyprus. One measure that would address both money-laundering compliance and competitiveness issues could be restructuring and computerizing the company registrar's office, which has proven resistant to reform for decades. If German parliamentarians are not satisfied and the funds do not come before 3 June, when government is due to pay a €1.4bn four-year EMTN, then the government will default. Even before that, if the funds do not come by the end of March, the government will have to continue using extraordinary short-term measures to meet its budgetary needs for another few months. In December it borrowed €150m from CYTA's pension fund, €100m from the EAC and €50m from the Cyprus Ports Authority to see it through until the end of March.

## Economic trends and forecast Jump to next section Revert to previous section

### We have revised down our growth forecast in 2013

The continued uncertainty surrounding the bailout for Cyprus has led us to revise down our forecast. We now expect a real GDP decline of 3.0% in 2013, compared with 2.6% previously. This remains milder than the government forecast of 3.5% for two key reasons. First, as explained in our December report, the de-stocking seems to be bottoming out and this will have an important impact on the growth rate going forward. Second, there was already a considerable negative impact on consumer and business spending in 2012 as a result of the uncertainty surrounding a bailout. We assume that the economy will begin stabilize by the second half of 2013, thanks largely to external demand, and start to grow again by 2014. However, growth will not be enough to make a significant dent in the unemployment rate, which reached 14% in November according to (frequently revised) Eurostat estimates. We expect the unemployment rate to rise to an average 14.3% in 2013 from an estimated 12% in 2012 (see Table 1 above). The inflation rate, which is already falling, is expected to drop to 1.6% in 2013 from 3.1% in 2012, thanks to weak demand, stabilizing oil prices, which have a strong impact on electricity prices owing to imported fuel oil, and the fact that VAT increased by 1 percentage point in January 2013 compared with 2 percentage points in 2012.

**Table 6**

**Real GDP growth forecast**
% change over same period of previous year

| | 2010 | 2011 | *2012* | *2013* | *2014* |
|---|---|---|---|---|---|
| Private consumption | 1.5 | 0.2 | *-2.2* | *-3.2* | *-1.4* |
| Government consumption | 1.0 | -0.2 | *-3.7* | *-3.4* | *1.2* |
| Gross fixed capital formation | -4.9 | -13.1 | *-21.1* | *-13.2* | *-9.0* |
| Inventories (contribution to growth) | 1.8 | -0.5 | *-1.5* | *0.9* | *0.8* |
| Total domestic demand | 1.9 | -2.8 | *-7.0* | *-3.7* | *-1.0* |
| Exports of goods + services | 3.8 | 3.3 | *2.9* | *1.2* | *2.2* |
| Imports of goods + services | 4.8 | -4.1 | *-7.8* | *-1.2* | *-1.0* |
| Net exports of goods + services (contribution to growth) | -0.7 | 3.5 | *5.1* | *1.1* | *1.5* |
| **Gross domestic product** | **1.3** | **0.5** | ***-2.1*** | ***-2.6*** | ***0.6*** |
| Average quarter-on-quarter growth rate, seasonally adjusted | 0.7 | -0.2 | *-0.6* | *-0.2* | *0.0* |

Source: Cystat; Sapienta estimates and forecasts in italics.

### We estimate that property prices are down 36% from their 2008 peak

One of the causes of uncertainty about the bank recapitalization requirement is how much banks will have to provision for real estate loans. At present, the local banks count as non-performing loans (NPLs) only those which are behind more than 90 days *and* whose value has fallen below the collateral held against them. The troika is insisting that *all* loans of more than 90 days due should count as NPLs and that the banks foreclose quickly on loans that are in arrears. Since most mortgages are based on repayment of both capital and interest and banks have not been allowed to lend more than 60% of the value of a property, the new definition should only have a significant impact on NPLs if property prices have fallen by more than 40%. Property prices in the third quarter of 2012 were 16.4% down from their peak in the third quarter of 2008 according to the Central Bank of Cyprus's index, but this is an hedonic index that takes into account changes in the quality of buildings so does not reflect falls in actual sales prices.

Sales prices of apartments have fallen 24.3% since the first quarter of 2010 (the earliest recorded period) according to the index of the Royal Institute of Chartered Surveyors (RICS). Using the average difference between the hedonic price index and the RICS index, we estimate that apartment sales prices have fallen by 36% since their peak in the third quarter of 2008. This means that the banks should in theory still be covered by collateral unless there was widespread over-valuation in the boom period. Meanwhile, with the exception of real estate value-added, which seems to be growing as a result of household formation, all indicators relating to the property market are in decline, thanks largely to an overhang of housing stock that built up during the boom years. Any move to clean up loans quickly would therefore push the real estate sector further into depression. However, given the long period in which it takes to enforce contracts in Cyprus (735 days according to the World Bank *Doing Business Report 2013*), it is unlikely that the banks will be able to foreclose as quickly as the troika demands.

**Table 7**

**Real estate indicators**
% change over same period of the previous year

| | 2011 Q3 | 2011 Q4 | 2012 Q1 | 2012 Q2 | 2012 Q3 |
|---|---|---|---|---|---|
| Real estate sales | -14.6 | -21.0 | 5.9 | 1.6 | -33.0 |
| Real estate prices (Central Bank of Cyprus hedonic index) | -4.2 | -5.7 | -5.0 | -5.9 | -5.8 |
| Real estate prices (RICS based on apartment sales prices) | -11.1 | -10.4 | -11.3 | -10.2 | -6.4 |
| Construction output | -16.3 | -13.5 | -16.7 | -24.7 | -17.1 |
| Total building permits authorised | -14.3 | -18.1 | -3.9 | -14.0 | -1.9 |
| Dwelling permits authorised | -19.6 | -43.9 | -45.1 | -30.8 | -32.5 |
| Real estate value-added in real terms (including imputed rent) | 4.0 | 3.8 | 3.2 | 2.9 | 2.8 |

Sources: Land Registry; Central Bank of Cyprus; Royal Institute of Chartered Surveyors Cyprus (RICS Cyprus); Cystat.

## Unemployment continues to hit unprecedented levels

One of the most notable features of this recession has been the rapid increase in unemployment. Between 1998 and 2007 Cyprus enjoyed an average unemployment rate of just 3.4%. But this has risen steeply since 2008, reaching 14% in November according to Eurostat's (frequently revised) estimate. Moreover, youth unemployment is now above 25%. In the absence of high growth rates, high unemployment is likely to be a feature for the foreseeable future unless there is significant emigration: 30% of the registered labour force is non-Cypriot and Cyprus has the highest tertiary education rate (50%) in the EU according to Eurostat figures for 2010, which potentially makes the young unemployed population very mobile.

**Table 8**

**Labour force**

| | 2011 Q4 | 2012 Q1 | 2012 Q2 | 2012 Q3 | 2012 Q4 |
|---|---|---|---|---|---|
| **Labour force survey** | | | | | |
| Labour force | 433,907 | 434,236 | 439,954 | 442,483 | n/a |
| Employed | 395,122 | 386,069 | 390,213 | 389,046 | n/a |
| Unemployed | 38,785 | 48,166 | 49,742 | 53,437 | n/a |
| Unemployment rate (%) | 8.9 | 11.1 | 11.3 | 12.1 | n/a |
| **Other unemployment indicators** | | | | | |
| Registered unemployed | 30,556 | 37,473 | 34,592 | 34,751 | 38,633 |
| Eurostat estimated unemployment rate (%) | 9.5 | 10.3 | 11.5 | 12.5 | 14.0[a] |

[a] November only.

Sources: Cystat; Labour Force Survey; Eurostat.

## After a strong summer, tourism arrivals declined in the fourth quarter

Tourism arrivals declined by 4.1% over the year earlier in the fourth quarter, having enjoyed a strong third quarter in which arrivals rose by 7.0%. The main reason was a 9.3% drop in arrivals from the United Kingdom, the largest market and a 27.1% year-on-year fall in the number of arrivals from Germany, the third largest market. These declines offset the very strong growth in arrivals from Russia. After average growth in arrivals of 47.5% per year for three years, Russia is now firmly established as the second largest market and could, if this pace continues, surpass the UK within two years. The UK's share of the market dropped below 40% in 2012 from over 50% in the period 2000-08.

**Table 9**

**Tourism arrivals**
% change over same period of previous year apart from annual data

| | 2012 | 2012 Q1 | 2012 Q2 | 2012 Q3 | 2012 Q4 |
|---|---|---|---|---|---|
| UK | 959,459 | -0.5 | -5.9 | -5.7 | -9.3 |
| Russia | 477,119 | 26.1 | 36.6 | 49.9 | 39.6 |
| Germany | 141,002 | -15.0 | -3.5 | 4.4 | -27.1 |
| Greece | 132,985 | -6.7 | -4.5 | -3.4 | -2.5 |
| Sweden | 115,280 | -69.2 | 19.8 | -1.5 | -7.7 |
| Norway | 67,503 | -7.5 | 8.2 | 7.1 | -4.4 |
| Israel | 39,617 | 6.7 | 23.5 | 35.5 | 10.9 |
| **Total arrivals inc. others** | **2,464,903** | **-4.1** | **3.7** | **7.0** | **-4.1** |
| Revenue, € m | 1,761 | -6.5 | 1.6 | 13.3 | -16.6 |

Source: Cystat.

## Inflation moderates

High unemployment and economic contraction have put downward pressure on the EU-harmonized consumer price inflation rate, which dropped to 1.4% in the fourth quarter from 1.8% in the third, primarily as a result of falling food and clothing and footwear prices as consumers cut back on spending. Inflation in Cyprus is highly sensitive to international oil prices, as more than 95% of electricity is produced by burning heavy fuel oil and diesel.

**Table 10**

| **EU-harmonized consumer price inflation (HICP)** % change over same period of previous year | 2011 Q4 | 2012 Q1 | 2012 Q2 | 2012 Q3 | 2012 Q4 |
|---|---|---|---|---|---|
| Food & non-alcoholic beverages | 7.9 | 5.1 | 2.1 | 3.8 | 0.8 |
| Alcoholic beverages & tobacco | 9.4 | 2.1 | 3.5 | 1.2 | 2.9 |
| Clothing & footwear | 1.0 | -0.9 | -3.1 | -2.8 | -3.8 |
| Housing, water, electricity & gas | 9.7 | 11.4 | 11.6 | 9.0 | 6.2 |
| Furnishings, household equipment & supplies | 1.8 | 0.9 | 0.4 | -0.8 | -0.9 |
| Health | 3.2 | 1.1 | 0.6 | 0.4 | 0.1 |
| Transport | 2.4 | 2.6 | 4.6 | 5.1 | 4.8 |
| Communication | 2.2 | 0.2 | 1.3 | 1.4 | 1.5 |
| Recreation & culture | 0.5 | -0.2 | 0.1 | 0.6 | 0.3 |
| Education | 2.5 | 2.9 | 2.9 | 2.7 | 0.8 |
| Restaurants & hotels | 1.3 | 1.7 | 4.2 | 5.7 | 2.1 |
| Miscellaneous goods & services | 1.7 | 1.2 | 1.3 | 0.9 | -0.2 |
| **Harmonized consumer price inflation** | **3.8** | **3.3** | **3.4** | **4.0** | **1.8** |

Source: Cystat.

## Charts Revert to previous section