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In-Depth Review for CYPRUS

in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

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EXECUTIVE SUMMARY AND CONCLUSIONS

This in-depth review presents a broad scrutiny of the Cypriot economy with a view to identifying actual or potential imbalances and the possible macroeconomic risks which they may entail. The review emphasises the inter-linkages among the imbalances that characterise the economy and also highlights some particular structural features that have increased the vulnerability of the economy while reducing its ability to adjust to such imbalances.

While some imbalances have only emerged following the sharp recession and the collapse of the domestic credit boom, others have been building up over the past decade. During the boom period that followed EU accession and the subsequent introduction of the euro, low lending rates and easy access to credit prompted a credit-fuelled boom, which was reflected in a rapid rise in prices in the property market and a sharp increase in private sector indebtedness and leverage ratios. At the same time, unit labour costs rose as strong wage growth, underpinned by wage indexation (cost-of-living agreement – COLA), overtook the slower pace of labour productivity growth. These developments led to significant losses in cost and price competitiveness and witnessed the emergence of a rapidly growing trade deficit and persistently high current account deficits. The latter were financed mainly through foreign direct investment inflows (including reinvested earnings and undistributed profits of firms with foreign shareholding based in Cyprus) and, more recently, through "other investments" (deposits and loans). The net international investment position (NIIP) has deteriorated sharply in the past few years mainly as a result of the persistent trade deficits and sizable valuation losses on bank assets. The counterpart of high external indebtedness is high private sector debt, particularly in the non-financial corporate sector, notwithstanding the rising public sector debt.

While the economy was not subject to the severity of the fallout from the bursting of a housing bubble that afflicted several other euro-area countries, the recent worsening of short-term economic growth prospects and the adverse developments in the financial sector stemming from the latter's exposure to Greece have added to the economy's challenges in addressing the imbalances that have built up over time. The Cypriot authorities' delay in introducing discretionary measures to reduce the government deficit, and the rising expenditures on the public sector wage bill and social benefits have also exacerbated the existing imbalances.

The main observations from this review are:

- **Sizeable and persistent current account deficits resulted mainly from a deficit in the volume of trade, which is in turn linked to a gradual erosion of price/cost competitiveness.** Indeed, the latter was driven, under the impact of the boom of the early 2000s and domestic labour shortages, by wage growth outpacing productivity gains. The needed correction of the rise in relative unit labour cost should be facilitated by the current slack in overall demand and employment and by wage restraint in the public sector, which serves as a benchmark also for private sector settlements. At the same time, a shift of the supply structure towards goods and services of higher value added would help generate higher export revenues, notably in the tourism industry, which is an important source of revenue for the Cypriot economy. Insofar as the financing of the current account deficit is concerned, Cyprus was able to rely in the past on high external capital inflows from foreign deposits and foreign direct investment (FDI), also including re-invested profits of foreign companies in Cyprus. Such reliance represents a particular vulnerability should confidence in the sovereign and the private economy diminish.

- **The banking sector suffers from a large exposure to Greece, in terms of both the private sector and the sovereign, and needs to raise fresh capital.** The non-performing loans (as a percentage of total loans) of the non-financial corporations increased substantially, and are significantly higher than the percentage of non-performing loans of the whole private sector. Legislation has been put in place to accommodate, via public intervention, any risks to the viability of banks or need for recapitalisation that cannot be met by market operations. The situation in the Cypriot banking sector also threatens the sustainability of the country's position. The composition of the international investment position is a cause for concern, as it is characterized by risky foreign assets and liabilities dominated by foreign-held deposits. Any shock to the banking sector could thus have catastrophic consequences to the economy by compounding the challenges arising from Cyprus' internal imbalances.
- **The large amount of accumulated private sector debt is a source of concern.** Total private sector indebtedness (as a share of GDP) in Cyprus is the second highest in the EU, with the debt of non-financial corporations being particularly outstanding. In addition the net financial position of the non-financial corporate sector is negative. Most non-financial corporations in Cyprus are small enterprises and their main source of funding is loans from banks, in contrast to larger euro-area enterprises which have access to other sources of funding, such as shares and other equity. Given that external financing is constrained by prohibitively high interest rates, corporate investment relies crucially on the generation of higher private savings. The degree of household indebtedness is also among the highest in the EU although it is covered by substantial assets, leading to a positive net asset position. While household loans, most of which were granted for housing purposes, are well collateralised and households are on aggregate net lenders, the servicing costs of the debt absorb a relatively high share of household disposable income, implying an important vulnerability in terms of potential interest rate rises.
- **Domestically, government finances have swung to annual deficits that have widened even as the economy recovered from recession.** The general government deficit, at over 6% of GDP in 2011, exceeds the reference value of the Stability and Growth Pact by a wide margin and recent efforts to correct the excessive deficit, though substantial, may not prove sufficient. Likewise, **public debt has risen above the ceiling of 60% of GDP.** A credible consolidation strategy needs to address the issue of overstaffing, the generosity of social benefits granted independent of private needs, and the system of automatic and frequent salary adjustments. Control over government spending should be effectively reinforced by subjecting annual budgetary planning to a medium-term fiscal framework, which is about to be adopted.

In this context, **the in-depth review concludes that Cyprus is experiencing very serious macroeconomic imbalances, which need to be urgently addressed.** In particular, macroeconomic developments as reflected in the current account, public finances and the financial sector require close monitoring and urgent economic policy attention in order to avert any adverse effects on the functioning of the economy and of economic and monetary union.

The national authorities adopted an ambitious expenditure-driven consolidation strategy to correct the excessive fiscal deficit, to stabilise the banking sector, and to strengthen economic growth over the medium term. However, the size and scope of the identified imbalances, as well as their potential negative spill-over effects to other economies in the euro area call for a comprehensive adjustment and determined policy action on a sustained basis. Beyond the correction of the excessive fiscal deficit, restoring balance in public finances should be

supported by tight control over expenditure in the coming years, the adoption of a medium-term budgetary framework and the establishment of a fiscal council for the surveillance of budgetary execution, as well as by strengthening tax compliance and fighting against tax evasion. In order to restore external competitiveness, wage dynamics need to be better controlled by means of a thorough reform of the wage indexation system; in addition, upgrading the supply structure by a shift towards higher- value-added activities over the medium term would increase the scope for higher earnings from exports. Policies for the financial sector will need to strengthen regulatory provisions for bank recapitalisation and supervision of the cooperative societies. In order to reduce the indebtedness of the private sector, corporate legislation establishing liability for loan repayments and supervision of the granting of corporate loans will both need to be reinforced.

1. INTRODUCTION

On 14 February 2012, the European Commission presented its first Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device, helping to identify Member States that warrant further in-depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth reviews” should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists and what type of policy follow-up it will recommend to the Council.

For Cyprus, the AMR identified a need to look more closely at whether Cyprus was suffering from macroeconomic imbalances of an internal and an external nature. On the external side, the AMR highlighted the persistence of current account deficits, which prevailed together with a significant loss in export market shares and competitiveness over the last decade. On the internal side, the high degree of leveraging of the private sector was identified as a matter of concern despite its coexistence with substantial private sector assets. Such concern arises mainly from increasing household indebtedness in the context of the important exposure of the banking sector to Greece and the deterioration in the economic outlook and the fiscal situation.

Against this background, Section 2 of this review looks into these developments covering the macro-economic context and the nature of the existing economic imbalances together with their inter-linkages. This is followed by specific focus sections on the sustainability of the external positions and the internal positions (sections 3 and 4 respectively). Section 5 summarises the findings and presents policy considerations.

2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

2.1. Macroeconomic scene setter

More than a decade of sustained and strong economic expansion in Cyprus, with an average annual real GDP growth rate of 3.8%, came to an end when the crisis hit in 2009. For the first time in 35 years, economic activity in Cyprus contracted in 2009, falling to -1.9%. The setback in demand and output weighed on employment, particularly in labour-intensive sectors, such as construction and tourism. After a modest recovery in 2010, with GDP growth at 1.1%, economic activity expanded by 1.5% in the first half of 2011. However, despite an exceptionally good tourist season, growth prospects for the year as a whole were badly affected by the accident in July 2011, which destroyed the Vassilikos electricity producing plant that accounted for half of the country's total generating capacity. A worsening external environment and tightening financial and fiscal conditions compounded the damaging effect. As a consequence, annual GDP growth in 2011 turned out at a modest 0.5%.

Domestic demand, traditionally the main driver of growth, decreased considerably in 2011. Tightening bank lending conditions along with a deteriorating labour market outlook and weakening confidence weighed on private consumption. In addition, subdued foreign demand for housing and a restructuring of corporate balance sheets kept investment on a downward path for the fourth year in a row. On the other hand, the external sector made a positive contribution to growth. Revenues from tourism increased by 13%, helped by political instability in competing Mediterranean tourist destinations and an increased flow of arrivals from emerging markets such as Russia. In addition, import growth decelerated, in line

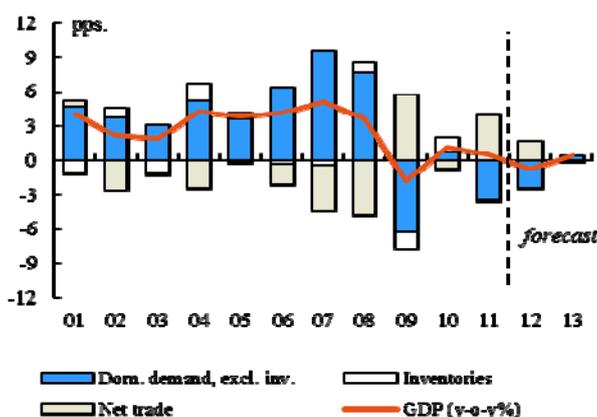
with the contraction in domestic demand. Nevertheless, with a current account deficit above 10% of GDP, the external imbalance remained sizeable.

GDP is projected to contract by 0.8% in 2012 due to a fall in domestic demand and a weaker external environment, notably including persistent financial market uncertainty.

Private consumption is set to be constrained by the squeeze in disposable income, especially among public sector employees and stemming from the fiscal restriction incorporated in the Budget Law, as well as by the rise in unemployment to unprecedented levels. The large exposure of the financial sector to Greece and the need for bank recapitalisation is likely to raise the cost of financing and limit access thereto by the private sector. Demand for housing is also expected to remain sluggish, while other construction investment is likely to benefit from reconstruction work in the destroyed Vassilikos power station and from other infrastructure projects. Leading indicators point to weak albeit improving consumer and business confidence. Accordingly, recovery should set in slowly during the second half of 2012 with the improvement of the external environment and the resumption of private investment as uncertainty slowly dissipates. The contribution of the external sector to growth is set to remain positive. While slowing global trade and worsening economic prospects in Cyprus' main trading partners are likely to weigh on exports of goods, this should be partly offset by healthy performance of business services and tourism. Imports are set to decline against the backdrop of weak domestic demand, allowing the current account deficit to narrow further to around 7.8% of GDP in 2012.

Economic activity is projected to recover only gradually in 2013, mainly driven by exports and private investment, while domestic consumption will remain constrained by the need for further correction of economic imbalances.

Graph 1: Contributions to GDP growth



Source: Commission services.

The unemployment rate remains on a rising trend, reaching an average of 9.5% in 2012, up from 7.8% in 2011. The Cypriot economy enjoyed a strong employment boom before the crisis. The number of jobs grew by 26% between 2000 and 2008. While the subsequent job losses have been relatively moderate at around 2%, unemployment has risen quickly from traditionally low levels, due to continued inflows into the labour force.

2.2. The emergence of imbalances and their implications

Cyprus faces both external and internal macroeconomic challenges. Although some of the imbalances have emerged following the sharp recession and the collapse of the domestic credit boom, others have been building up over the past decade. Accession to the EU in 2004

led to an increase in FDI inflows. The introduction of the euro in 2008 coincided with the start of a prolonged boom in the economy. During this period, low lending rates and easy access to credit prompted a credit-fuelled boom, which was reflected in a rapid rise in prices in the property market and a sharp increase in private sector indebtedness and leverage ratios. At the same time, unit labour costs rose as wage growth - mainly due to wage indexation (cost-of-living agreement – COLA) - overtook the slower pace of labour productivity growth arising from the delayed introduction of needed productivity-enhancing structural reforms. These developments led to significant losses in cost and price competitiveness and witnessed the emergence of a rapidly growing trade deficit (including an erosion of the surplus on trade in services) and persistently high current account deficits. The latter have been financed mainly through FDI inflows (including reinvested earnings and undistributed profits of firms with foreign shareholding based in Cyprus) and, more recently, through "other investments" (deposits and loans). As in many other countries, the underlying challenges were starkly revealed with the onset of the global financial and economic crises. While the economy was not subject to the severity of the fallout from the bursting of a housing bubble that afflicted many other euro-area countries, the recent worsening of short-term economic growth prospects and the adverse developments in the financial sector stemming from the latter's exposure to Greece have added to the economy's challenges in addressing the imbalances that had built up over time. The Cyprus authorities' delay in introducing discretionary measures in reducing the government deficit, along with the significantly rising government wage bill and the social benefits, worsened the existing imbalances.

Since the financial market crisis and the deep recession, Cyprus has been *de facto* excluded from international capital markets. While the sovereign, for the time being, can cover its financing needs through ad-hoc arrangements (e.g. the Russian loan), the private sector will be constrained by the need to fund domestic private investment through private savings in the event that no net external financing is available. Sustaining investment growth in such circumstances thus requires higher household savings, i.e. lower consumption, which would weigh on growth via final demand. Otherwise, corporate investment will be squeezed by tighter monetary conditions, through either high bank lending rates or credit rationing. The situation could be exacerbated if, in addition, the sovereign and/or the banking sector were to put additional claims on private savings. The long-term refinancing operations (LTROs), completed by the Euro-system in end-February, could in theory play an offsetting role. It is however still too early to assess it. If anything, bank loans to domestic residents declined by some EUR 770 million, i.e. 1.5%, between February and March 2012.

For many years in the past, Cyprus was able to rely on high external capital inflows from foreign deposits and FDI (also including the re-invested profits of foreign companies in Cyprus) to finance its current account deficits. However, the crisis has shown that such reliance is fragile. The huge swing from net capital inflows to outflows suggests that FDI flows can be quickly reversed if confidence in the sovereign and the private economy fades away. Sales of real property by foreigners have exacerbated this trend. Therefore, a surplus in the current account should be achieved in order to reverse the accumulation of high net external liabilities and ensure the financing of the domestic economy, including the sovereign, in the medium term.

As mentioned above, during the boom earlier in the last decade, competitiveness was eroded, leading to a structural current account deficit, inter alia for tourism services. The recent re-orientation towards Cyprus as a tourist destination may be owed to special circumstances and may prove short-lived if competitiveness is not restored. Likewise, domestic private consumption was fuelled by an over-sized public sector where high wage increases served as a benchmark also for private sector settlements. This highlights the need

to address the loss of competitiveness and the fiscal imbalance, both of which had been masked for years by low interest rates and the real estate boom.

3. EXTERNAL POSITIONS AND THEIR SUSTAINABILITY

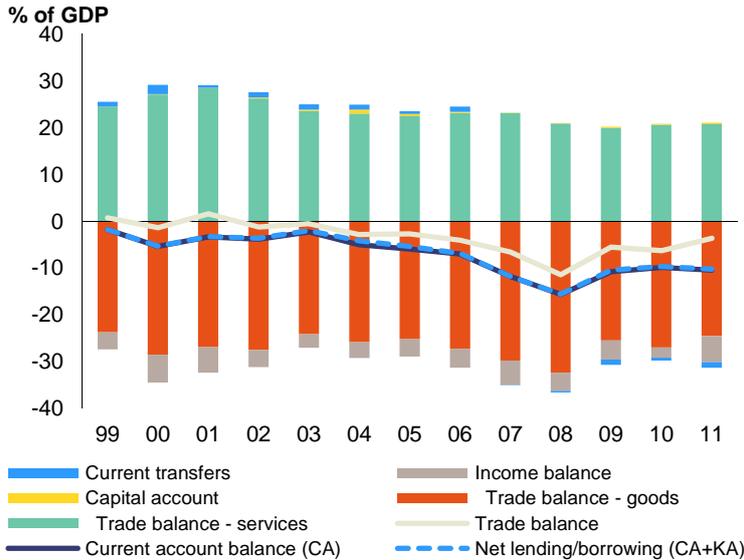
Cyprus's external imbalance is manifested in persistently high current account deficits over the past decade, mainly driven by buoyant domestic demand. The evolution of the Cypriot current account balance shows different patterns in the trade of goods and services, reflecting the shift of the Cypriot economy towards the tertiary sector. The negative trade balance in goods is partly compensated by the surplus recorded in the services trade. Cyprus suffered losses in price competitiveness in the years prior to the crisis, but this trend has been more contained in subsequent years.

3.1. Current account balance

3.1.1. Description and evolution of the current account balance

The Cypriot economy has been characterised by persistent current account deficits for more than a decade. From a close-to-balance position in the second half of the 1990s, the current account balance weakened progressively over the following decade, with the deficit reaching a record high of 15.6% of GDP in 2008, a year marked by booming economic activity, strong domestic demand, and the adoption of the euro. The external deficit moderated to 9.9% of GDP in 2010 and to 10.4% in 2011. In fact, since Cyprus's independence in 1960, the average current account deficit was 4.4% of GDP for the period 1960-2010, while for the period 2000-2010, the average deficit increased to 6.9% of GDP. With Cyprus' EU accession and entry into the euro area, the boom in construction activity, the increase in prices of raw materials (oil, iron, etc.), and the significant increase of goods import, the current account deficit increased considerably over the decade 2000-2010. As noted in the Alert Mechanism Report (AMR), the 3-year average of the current account deficit increased from 6.0% of GDP in 2004-2006 to 10.5% for the years 2009 to 2011, well exceeding the indicative MIP scoreboard threshold of -4% of GDP.

Graph 2: Evolution of the current account balance



Source: Commission services

A large increase in the current account deficit was witnessed in the years 2007 and 2008, with the deficit exceeding 15% of GDP. From a savings-investment perspective, the

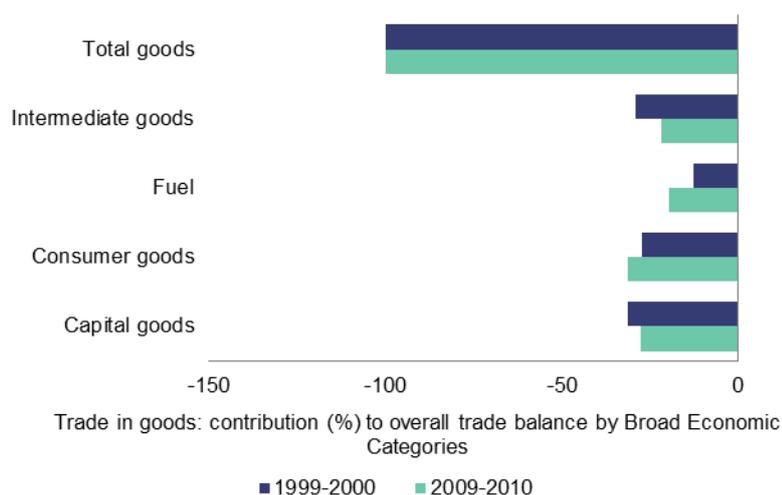
analysis of the data suggests that this increase essentially reflected a steady worsening of the net financial position of the private sector. On the back of a fall in risk premia and easing of financial conditions, the private sector savings fell sharply. In parallel, credit grew at double digit rate in 2007-2008 (adoption of the euro in 2008) owing to the overheating of the economy with growth concentrated in construction, real estate, renting, and business activities. The deterioration in private sector balances was partially offset by an increase in public sector saving, as government accounts recorded surpluses. Nevertheless, the unwinding of the financial market crisis and the burst of the real estate bubble saw a reversal of these trends. Public sector dissaving have been more than compensated by savings from the private sector, leading to an improved current account balance. The current levels of the current account balance are associated with a period of subdued domestic demand, on the backdrop of tepid consumption and construction investment activity.

As evident in Graph 2, the prominence and role of the goods and services balance in Cyprus's current account balance suggest that the trade balance is most relevant in assessing the sustainability of the external position. The small size of the Cypriot domestic market and the economy's openness and integration into the outside world mean that foreign trade plays a pivotal role in the country's economic development and performance. This heavy reliance on foreign trade is reflected by sum of imports and exports of goods and services which reached about 100% of GDP for the period 2000-2010, compared to less than 40% on average for the euro area countries. The two other components of the current account balance, i.e., the income account balance and net current transfers, while accounting for smaller shares of the overall balance, are of particular importance, given the strong presence of foreign-owned companies in Cyprus and the effect of their investment decisions and current business operations (i.e. direct investments) on cross-border capital and income flows.

The Cyprus economy exhibits persistent deficits in the merchandise trade of goods, ranging above 25% of GDP on average during the last decade and driven by a strong acceleration of imports. While the share of goods exports in GDP decreased to 7.5% of GDP on average during the last decade (compared to an average of 13.1% of GDP in the 1990s and 20.4% of GDP in the 1980s), the share of goods imports in GDP was at 37.8% in the last decade (42.5% in 1990s and 51.3% on average). The growth rate of import of goods (for domestic consumption and for re-exports), which had traditionally been much higher than the goods export, denotes the declining path of the domestically produced manufacturing goods (due to the progressive loss of their competitiveness), the shift of the economy towards the tertiary sector, the increase of goods imports for domestic consumption, and the increased dependency on oil imports. Cyprus' domestic exports (including re-exports) cover a range of manufacturing goods (major products being pharmaceuticals, photosensitive semiconductor devices, waste and scrap in 2010), followed by processed and raw agricultural products, and processed minerals. Consumer goods and intermediate products make up for most of total imports (around 58%) followed by fuels and lubricants (20%), transport equipment (13%) and capital goods (9%) in 2010. Imports surged to 32.4% of GDP in 2008 compared with 27.2% of GDP in 2006, partly as a result of higher oil prices, but most importantly due to imports of intermediate goods and raw materials related to the construction boom.

Apart from the growing burden of fuel imports, there has been a shift in the import structure towards consumer goods and away from intermediate and capital goods (see Graph 3). While part of this shift may be explained by the recent recession and the end of the construction boom, the apparent decline in investment bodes ill for the country's future growth prospects and the sustainability of the external deficit.

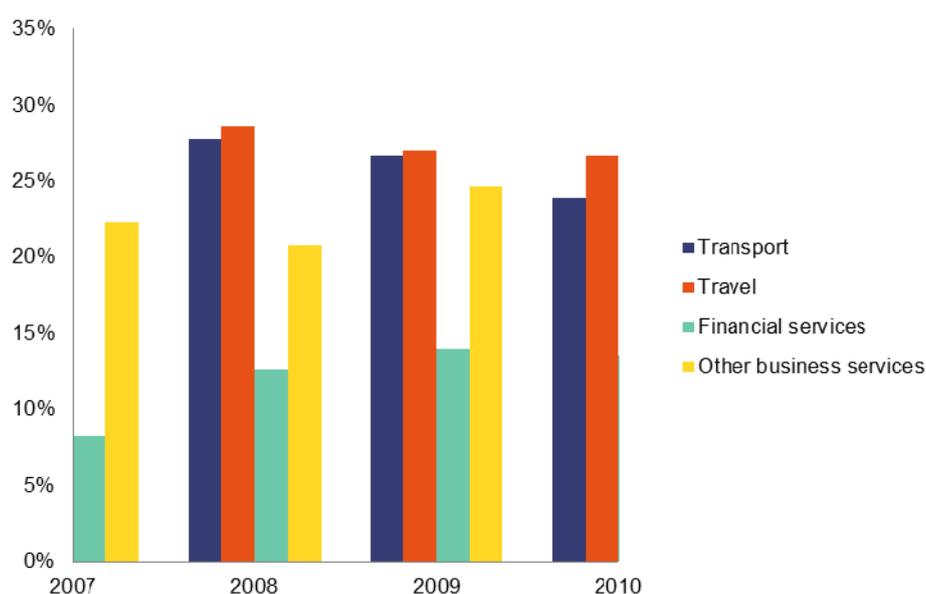
Graph 3: Trade in goods: contribution (%) to overall balance by broad economic categories



Source: Commission services

Cyprus developed a sophisticated services sector which has grown and become quite diversified. Over time, travel services have been the major category of exported services with the exception of 2010 when other business services took the lead. This was prompted by a decline in price competitiveness of the Cyprus tourism industry with the emergence of neighbouring countries offering comparable tourism services at attractive prices. Cyprus' accession to the EU and to the euro area, along with a favourable tax regime and the availability of highly-skilled labour stimulated the development of business services which in 2010 amounted to 11% of GDP (from 6% in 1995). It is worth noting that the share of financial services in total services balance increased significantly in the years 2007-2010, rising to 18.2% of GDP, positively affected by Cyprus's EU accession which increased Cyprus's role as a bridge between third countries and the euro area. Where imports of services are concerned, these are mainly related to transport and travel, with transport services being the major category given the high dependency of the economy on imports of goods.

Graph 4: Trade in services: contribution (%) to overall service balance by broad economic categories



Source: Central Bank of Cyprus

The orientation of the economy to the services sector led to the increase in services exports, resulting in persistent high surpluses in external trade in services, reflecting also shift of the Cypriot economy towards the tertiary sector. The surplus in services trade reached a peak of 28% of GDP in 2001 and stood at 21% of GDP in 2010. Noteworthy has been the performance in the exports of business and financial services, reflecting the comparative advantages of Cyprus as an international business and financial centre. The observed variations in the trade surplus as a percentage of GDP can be attributed to the higher volatility of exports as the import of services follows a more stable trend. These surpluses in the service trade compensated largely, but not fully, for the negative balance in the trade of goods.

The progressive decline of exports of services as a percentage of GDP observed during 2001-2009 was driven mainly by reduced revenues from the tourism sector. The latter was to a large extent due to reduced competitiveness and to a lesser extent to reduced government services (reflecting an expenditure-constraint decision of the British government to downsize the operation of the sovereign British Bases present in Cyprus). It is also attributable to the prevailing worsened external environment. Yet, despite this decrease in the recent years, the trade balance recouped some of its loss in 2010 reaching 20.7% of GDP from 19.9% in 2009.

The balance of trade in goods and services has been running persistent deficits since 2002 (average deficit of 4.61% of GDP for the period 2002-2011). The progressive loss of competitiveness of domestically-produced goods (mainly manufactured goods), which became evident with the liberalisation of trade and the accession of Cyprus to the EU, together with the shift of productive resources to the tertiary sector (tourism, financial and other business services) led to the decrease in exports of goods. At the same time, imports of goods, primarily for domestic consumption, expanded swiftly, reflecting the acceleration and changing composition of GDP growth, which was essentially driven by domestic demand and fuelled also by an expansionary fiscal policy. Noteworthy are also exogenous factors affecting the Cyprus economy such as rising prices for oil, food and other commodities, on which Cyprus is highly dependent (Cyprus' energy needs are predominantly met by imported oil). Indicatively, the import of oil products during 2007-2010 reached 5.5% of GDP during 2007-2010. Also important is the level of import of defence equipment (which affects the trade balance but is not linked to competitiveness issues). The overheating of the domestic economy before the financial crisis, in particular of the construction sector, also led to higher imports of goods for construction purposes. The rapid growth in unit labour costs and the associated real exchange appreciation which led to Cyprus goods being increasingly priced out of international markets, also took a toll on the export side of the trade balance.

The trade balance of goods and services (as one of the indicators for competitiveness and external sustainability of a country) has narrowed substantially during the last four years, from a deficit of 11.4% of GDP in 2008 to a deficit of 3.6% of GDP in 2011. Looking forward, while slowing global trade and worsening economic prospects in Cyprus' main trading partners are likely to weigh on exports of goods, this should be partly offset by healthy performance of business services and tourism. Imports are set to decline against the backdrop of weak domestic demand, allowing the current account deficit to narrow in 2012.

The income account has recorded a negative balance ranging from -5.9% of GDP in 2000 to - 2.2% of GDP in 2010. During the last decade, the income account balance has been fluctuating slightly around an average of -4.1% of GDP. Comprising two main items, cross-border compensation of employees and investment income, the importance of the income balance in Cyprus' current account balance has been growing over time. This is due to the increasing number of firms with foreign shareholding based in Cyprus (through direct

presence, subsidiaries or foreign branches) that chose to channel their operations via Cyprus, attracted by the country's favourable tax regime¹. Their growing importance is reflected by the increased payments on their investments as a share of GDP from/to Cyprus.

In a small open economy, the heavy presence of foreign companies can distort economic balances to some extent, as the income flows recorded do not necessarily reflect underlying economic transactions related to the competitiveness of the domestic economy. According to the Central Bank of Cyprus, if a foreign-owned company reports undistributed profits (or if it re-invests its earnings) in a certain year, these are recorded as a debit item (outflows, under direct investment income²) in the income account and simultaneously, under the double entry system, a credit is recorded in the financial account with direct investment in Cyprus increasing by an equal amount. In this case, an outflow appears in the income of the current account balance even though there is no underlying transaction. The transaction is then recorded as an inflow in the financial account, namely in the form of FDI. In this way, the increase in the current account deficit is automatically financed. However, it should be also noted that should accumulated reinvested earnings and undistributed profits be given as dividends, then future finance needs of the current account deficit could be at risk. Noteworthy is the fact that during the current financial crisis, no such risk have materialised so far.

The net flows of portfolio investment income (in bonds and notes) and other investment income (deposits and loans) have been predominantly positive since 2000. This reflects Cyprus' efforts to become a regional financial centre, attracting foreign deposits that also generate investment income. The financial sector accounts for the bulk of portfolio investment transactions and positions. Observed fluctuations in portfolio investment income during the years 2008 and 2011 relate mostly to decisions of companies to transfer foreign debt securities within their company group rather than a true reshuffling of foreign financing. As regards the deposits of non-residents (mainly of companies registered in Cyprus but with no physical presence in Cyprus), which are recorded in the other investment under the income account, their growth rate has been increasing steadily and consistently. During the years 2007-2010, deposits of non-residents increased by 59%³. A small reduction is observed in 2011 but that mainly reflects a correction from the high growth rates recorded from 2009 to 2010. Noteworthy is the prudential liquidity requirements put in place for non-resident deposits imposed by the Central Bank of Cyprus in order to ensure that the banks can withstand severe withdrawals. There is a 70% stock liquidity requirement imposed on banks in relation to their foreign currency customer deposits.

As regards current transfers (mainly of the general government) in the current account balance, there has been a shift from a positive balance for the years 1999-2007 to a negative balance in the subsequent three years (equal on average to -0.7% of GDP). This shift is mainly due to Cyprus changing from net receiver of EU funds during the years 2004-2007 to a net contributor to the EU budget, i.e. payments by the Cyprus government to the EU are higher than EU transfers to Cyprus.

¹ Cyprus has the lowest corporate tax regime in the EU at 10% while dividend income, profits from overseas permanent establishments and profits from the sale of securities are exempt from tax, with no withholding tax on dividend, interest and royalties paid from Cyprus. The favourable tax framework is combined with a range of double tax treaties with over 43 countries worldwide while as an EU member, Cyprus tax legislation is in line with EU law.

² The term foreign direct investment means the participation of more than 10% in the share capital of an enterprise resident in one country by an investor resident in another country (direct investor); this implies the existence of a long-term interest on the part of the foreign investor.

³ Data from the Stability Programme of the Republic of Cyprus, 2012-2015, Ministry of Finance, May 2012.

Developments in the income account and in current transfers largely derive from factors that are exogenous to the economy (business transactions of foreign companies in Cyprus and change of Cyprus from EU net receiver to contributor). These factors have contributed by more than half to the deterioration of the current account balance, since 2004. The worsening of the income account reflects mostly the higher debits for reinvested earnings. The losses recorded by commercial banks on their operations in Greece have affected also the income account for 2011 and are expected do so in 2012 as well. In fact, the income balance is expected to have recorded a deficit of 5.1% of GDP in 2011, considerably up from 2.2% of GDP in 2010, as these are losses recorded by domestic commercial banks for the operations abroad (i.e., in Greece), and thus will affect negatively the credit side of the income account.

Apart the exogenous factors affecting developments in the current account balance, export earnings from tourism appear to be eroding. Data suggest a considerable reduction of revenues from exports of services, mostly in the travel sector (from 14.4% of GDP in 2004 to 10.2% of GDP in 2011) which have been partly counterbalanced by revenues from financial services and other business services. While this underlines the structural shift of the economy towards financial and other business services, it may also point to competitiveness concerns for the tourism industry.

If services exports are to act as a counterbalance to the merchandise trade deficit in the future, competitiveness needs to be restored through wage restraint (thus, enhancing cost/price competitiveness) and productivity gains (through structural reforms to enhance productivity) The fiscal measures adopted by the government on 16 December 2011 in an effort to bring public finances on a consolidation path include measures that affect wages, primarily of the public sector but also of the private sector (for example, the freeze of emoluments in the public sector, and the temporary suspension of the cost of living allowance –COLA– for public wages which is also applicable to the private sector). In an effort to enhance the country's growth potential, employment, productivity, and competitiveness, the government prepared a wide-ranging package of measures, adopted by the Council of Ministers while some related legislative acts pends adoption by the Parliament, comprising of actions to support employment, measures to support public and private investments and to enhance the role of Cyprus as an international business and financial centre providing high value added services. The measures are intended to form a response to the economy's contraction at a time when fiscal consolidation measures would be in full effect. While these developments are first steps in the right direction for Cyprus to regain and sustain competitiveness, their relevance and credibility depends crucially on the degree of enforcement.

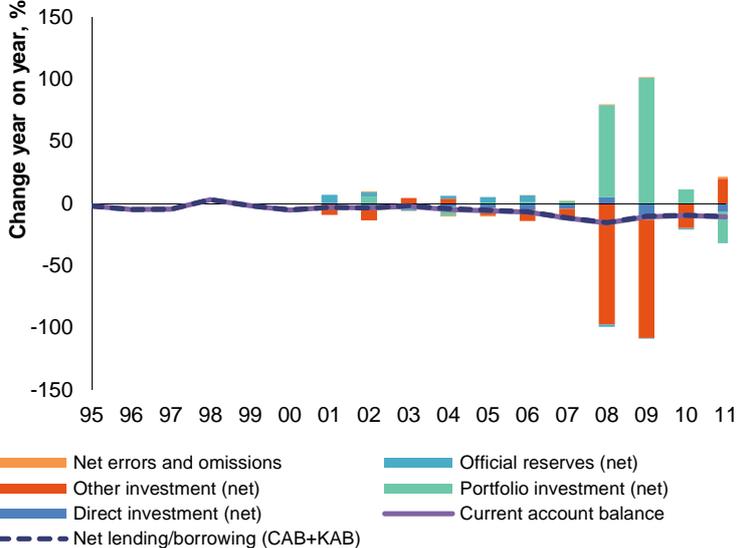
3.1.2. Financing of the current account balance

The significant surpluses of the financial account arising from foreign direct (inward) investment have constituted the most important source of financing of the current account, averaging 3.8% of GDP in the years 2004-2006 and 7.4% of GDP in the years 2009-2011⁴. Interestingly, the value of foreign direct investments reaches 4.4% of GDP for the years 1995-2010, by comparison to an average of 5.4% of GDP of the current account balance during the same period. This positive net foreign direct investment (FDI) inflow represents mostly monetary flows in the form of retained profits (reinvested earnings) of firms with foreign shareholding based in Cyprus. FDI coverage of the current account deficit has been significant, albeit volatile, over the years, averaging close to 60% for the period 2000-2007. Within FDI, reinvested earnings and undistributed profits of firms with foreign shareholding based in Cyprus reached 1.9% of GDP in 2004 to 2006 increasing to 3.5% in

⁴ Statistical data from the Central Bank of Cyprus.

2009 and 2011 that are debited to the current account balance. In 2008, reinvested earnings amounted to 53.5% of inward FDI, the highest share since 2000.

Graph 5: Components of the net borrowing/lending position of Cyprus



Source: Commission services

Foreign capital is overwhelmingly concentrated in tradable services, particularly financial services, but also increasingly in other business services like accounting, legal services and consulting, as well as IT activities. Beyond FDI, other inflows have also been sizeable, essentially reflecting a significant inflow of non-resident deposits, mainly from the Commonwealth Independent States and Greece, held in the Cypriot financial sector. Capital transfers have been very low in net terms as inflows from the EU were essentially offset by contributions to the EU. During the latter years of the last decade, inflows were negatively affected by subdued external demand for housing from non-residents in 2008, while outflows resulted from sales by foreigners of their holiday properties in Cyprus.

This trend increased the vulnerability of the economy to shocks (see also Kyriacou and Ktoris (2012)). Indeed, external financing by means of “other investment” a source of short-term financing, as these investments are in the form of deposits and notes, while direct investments have a longer-term horizon and also add to the productivity capacity of the country.

Table 1 illustrates the dynamics of the external financing of the current account balance in Cyprus: it shows the impact of the FDI inflows on the size of the current account balance and at the same time, its automatic offsetting through the financial account of the current account balance. It should be noted that dividends and re-invested earnings usually move in opposite directions, i.e., higher dividends declared for the period means lower re-invested earnings for that period (the impact on the current account balance is neutral irrespective of the shareholders' decisions to retain and re-invest or to distribute some of the enterprises' earnings). Looking at 2010 data, it appears that foreign shareholders decided to distribute big amounts of the companies' earnings and this resulted in lower net re-invested earnings.

If ones excludes the impact of the re-invested earnings and of dividends (the levels of which are often large compared to the domestic economy, and which are unrelated to the domestic economic activity (in balance of payments treatment)), then the current account

balance would have fallen within the indicative thresholds of the MIP scoreboard (-4%/+6% of GDP), although still resulting in current account deficits.

Table 1: Impact of reinvested earnings and dividends on the current account balance in Cyprus

as % of GDP	2003	2004	2005	2006	2007	2008	2009	2010	2011
Current account balance	-2.3	-5.1	-6	-7	-11.8	-15.6	-10.7	-9.9	-10.4
Current account balance (excl. reinvested earnings)	-2.2	-3.9	-4.1	-4.3	-9.3	-15.6	-4.7	-11.3	-4.4
Current account balance (excl. reinvested earnings and dividends)	0.2	-1.4	-1.6	-1.6	-5.2	-12.1	-5.5	-5.6	-2.8
FDI	2.4	2.5	3.7	5.2	4.5	-5.2	13.2	0.4	8.5
FDI (excl. reinvested earnings and undistributed profits)	2.3	1.3	1.8	2.5	2.1	-5.2	7.2	1.8	2.5

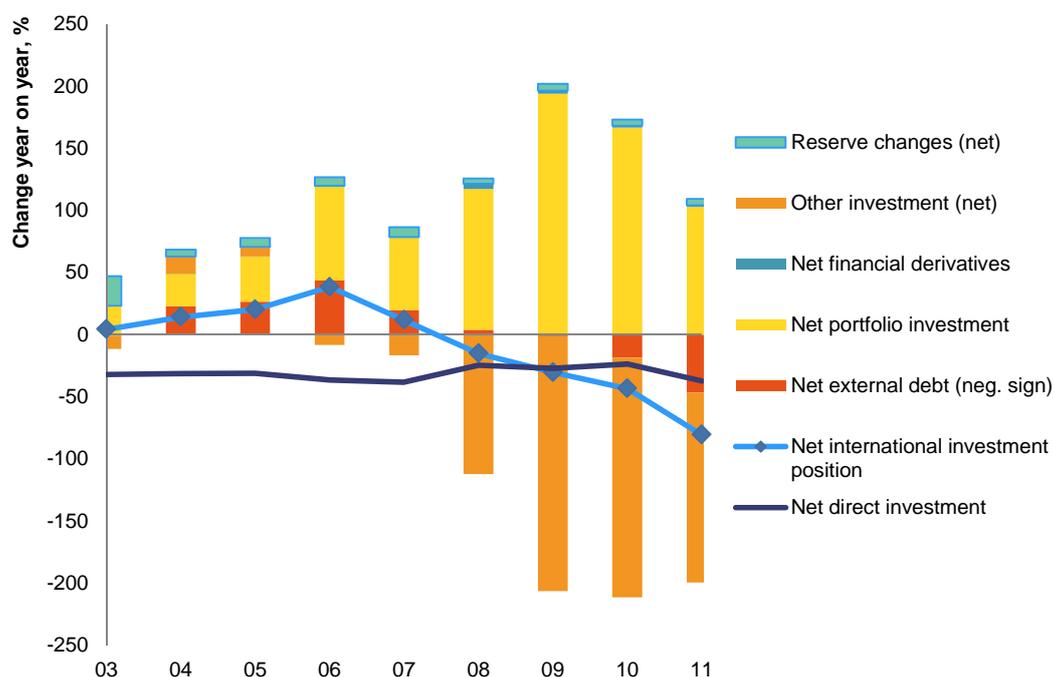
Source: Central Bank of Cyprus, April 2012

Yet, while the financing of the current account deficit has not caused great concern in the past, given the large inflows of FDI and non-resident deposits, the continued availability of these flows may not be guaranteed in the future. In particular, the repeated downgrades of the Cypriot sovereign debt, deteriorating growth prospects and the current challenges faced by the banking sector may pose risks for Cyprus' attractiveness to foreign investment. In the same vein, the continued slowdown in the rest of the EU and damped profitability due to the international economic crisis may also prompt a decline in foreign demand and FDI inflows.

3.1.3. Net international investment position

Along with the increased debt financing of the persistent current account deficit, there has been an increase in external liabilities, as seen by the deterioration in the net international investment position (NIIP). At a level of 43.4% of GDP in 2010, it was much higher than the indicative MIP scoreboard threshold of -35% of GDP. Looking at the available data from 2004 onwards, the net international position of Cyprus was positive for the years 2004-2007, while turning negative in 2008. The NIIP decreased from a positive 11.7% of GDP in 2007 to a negative 15.1% in 2008, deteriorating further to -30.4% in 2009, -43.4% in 2010, until NIIP fell to -80.7% of GDP in 2011 and ranked among the most negative in the EU. These developments were fuelled by large current account deficits since EU accession, changes in price, exchange rate changes, and by losses due to devaluations from Greek sovereign debt holdings.

Graph 6: Components of the net international investment position (% of GDP)



Source: Commission services

The net (stock of) direct investment (originating mainly from Greece, Russia and the UK) is negative (Graph 6). This fact is also reflected in the tendency for FDI inflows to provide the main source of financing for the current account deficit.

The evolution of the stock of "other investments (net)", which has become progressively negative since 2006, is critical to the analysis of the net international investment position. This is largely explained by the increasing stock of non-resident deposits in Cyprus (i.e. including deposits of foreign owned companies with no physical presence in Cyprus), which are attracted by favourable tax incentives for their intra-group transactions. The increase recorded from 2008 to 2009 is mainly attributed to the increase of loans due to MFIs abroad. Changes in the following years reflect a decrease of loans and a small increase of non-resident deposits.

The deterioration of the net international investment position, a fall of 65.6 pps. of GDP from 2008 to 2010, reflects mainly changes of the portfolio investments relating to intra-group transfers of foreign debt securities between Cyprus resident MFI's and their parent MFI's in Greece, (recorded as balance of payments transactions), driven in turn by tax incentives within the group (i.e. to benefit from reduced tax on income earned from securities), and does not reflect a true reshuffling of foreign financing. In addition, in 2010, there was a merger of a Cypriot MFI with the parent MFI in Austria, which resulted in the reduction of a considerable amount of stock value in international investment position, in both assets and liabilities.

The deterioration of Cyprus's net external debt, from a positive 4% of GDP in 2008 to a negative 18.4% of GDP in 2010, is related to the value of non-resident deposits in Cyprus, which account for almost 50% of the country's external debt. A substantial rise in the net external liabilities in 2011 is partly the result of a reduction in the valuation of foreign assets owing to losses on holdings of Greek government bonds (PSI) (statistics show that banks'

bond purchases have been heavily concentrated primarily in Greece, followed by the UK) and to non-performing loans extended to the Greek market.

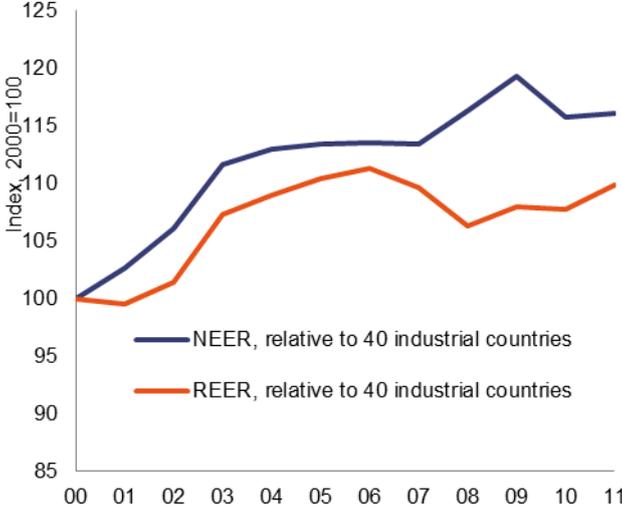
Given that the financial system in Cyprus is in the midst of formidable re-capitalization efforts following the latest EU aid package to Greece and the PSI, developments need to be monitored closely and policy must keep up efforts to strengthen the legal and institutional framework of the financial sector, given its crucial importance for the entire Cypriot economy. Problems with the banking sector could easily spill over to the financing of the current account deficit. The restructuring of the banking sector should be done in a way to reduce its feeding of risks to external sustainability.

3.2. Competitiveness

3.2.1. Real effective exchange rate

Between 2000 and 2009, Cyprus experienced a substantial appreciation in the real effective exchange rate⁵ vis-à-vis a set of 35 industrial countries (IC35). While this appreciation mirrors wage growth in excess of productivity gains to a certain extent, part of the apparent loss in competitiveness is also attributable to the appreciation in the nominal effective exchange rate. The latter partially reflected the appreciation of the euro, to which the Cypriot pound was pegged before the country’s accession to the euro area. In early 2007, the exchange rate establishing the irrevocable fixing of the Cyprus pound to the euro was considered to be broadly in line with equilibrium at that time. In 2010, this trend of effective exchange rate appreciation decelerated, as a result of the subdued economic activity and moderating inflation.

Graph 7: REER - Cyprus vs. euro area, NEER - Cyprus vs. 40 industrial countries (2000=100)



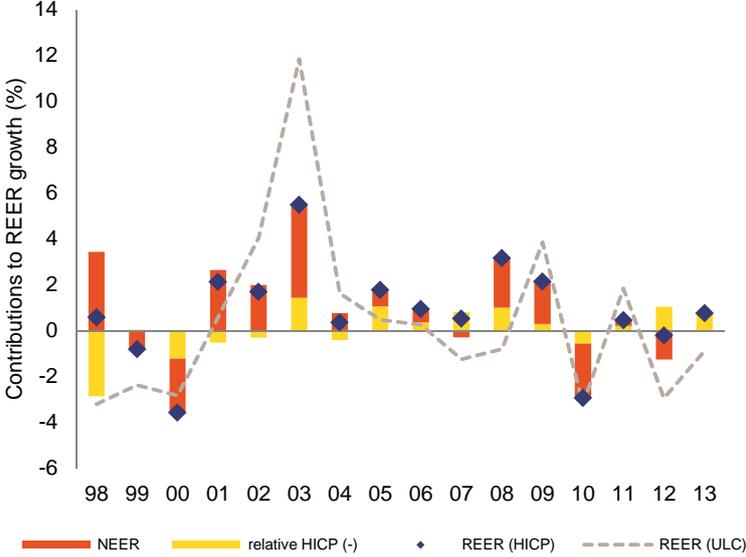
Source: Commission services

During the last ten years, the degree of appreciation depends on the indicator used - from 16.75% (GDP deflator) to 10.5% (export price deflator). Since neither deflator provides an accurate indication of the degree of competitiveness of the tradable sector – the former because it refers to the economy as a whole and the latter because it is an ex post measure for the export sector – the most likely degree of appreciation is likely to lie somewhere within this range. In terms of the deflator of private consumption, the REER appreciated by about

⁵ This trend is evident from the REER based on various price/cost indicators including the private consumption deflator, the GDP deflator, the export price deflator, and ULC-total economy.

14.25%. This was influenced by the increase in indirect taxes, as part of the VAT harmonisation process of Cyprus to comply with the EU *Acquis*, as well as by temporary factors, such as rising energy and commodity prices in 2008.

Graph 8: Change in the nominal and real effective exchange rates vis-à-vis the IC35



Source: Commission services

Against the euro area, developments in the real effective exchange rate were relatively more benign. The ULC-based REER appreciation over the period was about 6½%, mainly reflecting wage growth above the average for the rest of the euro area, while productivity growth on par with or even slightly faster than the average for the rest of the euro area. As claimed by the IMF the unit labour cost based real effective exchange rate appreciated before the EU accession, and unlike in other EU euro area countries, there was hardly any real depreciation in the ULC-based measure in response to the downturn in 2010. This lack of downward flexibility is likely to be caused by wage rigidities imposed by the cost of living adjustment, which indexes wages to past inflation.

3.2.2. *Unit labour cost and price developments*

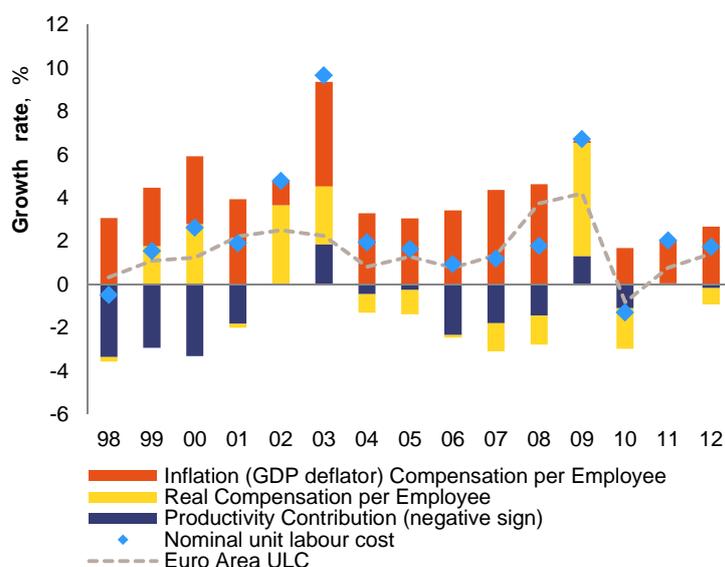
In the specific case of a small, open, services-oriented economy like Cyprus, joining the euro area gave a more prominent role to price/cost and productivity developments as a means of safeguarding external competitiveness (in the absence of exchange rate flexibility within the euro area). While productivity in Cyprus grew at the same pace or even slightly faster than the average of the rest of the euro area over the last decade, wages grew at a significantly higher rate. As a result, unit labour costs (ULC) increased faster than the average for the rest of the euro area, implying a steady loss of Cyprus' competitiveness vis-à-vis its main trading partners (euro area countries and the UK). Real ULC accelerated between 2001 and EU accession, mainly driven by fast growth of labour costs, while they were on a decreasing path in the euro area during the same period. After falling below the average euro-area ULC in 2008, the gap reopened in 2009 as a consequence of the global economic downturn which hit Cyprus with a lag, and following significant wage increases recorded that year.

During the last decade, labour productivity in Cyprus grew slightly faster than the average for the euro area. Buoyant growth in conditions of full employment and low

inflation in a business-friendly tax environment led to high productivity advances and were conducive to Cyprus' successful real convergence with the EU and accession to the euro area. Cyprus' real GDP was growing at an annual average rate of 3% between 2000 and 2010 (3.75% vs. 2% between 2000 and 2008), compared with 1.4% in the euro area average while employment grew by 2.2%, sustained by inflows of foreign workers and a historically low unemployment rate.

However, prices and wages grew faster. The rates of change of the consumer price index (CPI), the producer price index (PPI) and labour costs all exhibited steadily positive gaps with respect to the corresponding averages for the euro area. However, as pointed out by the IMF while relative CPIs may represent an inaccurate indicator of external competitiveness since the CPI includes a significant share on non-traded consumption goods and is subject to distortions arising from taxes and subsidies, relative PPIs and labour costs provide better indicators of competitiveness in the tradable sector. A comparative analysis using both of the latter indicators suggests a persistent competitive disadvantage of Cyprus with respect to trading partner countries in the euro area.

Graph 9: Contributions to the rate of change of unit labour costs in Cyprus



Source: Commission services

Although the value for the MIP scoreboard indicator for ULC does not exceed the threshold in 2010 (7.2% change in the 3 years up to 2010 compared to the benchmark level of 9%), the effect of the inflation component of the ULC is worth noting. The twice-a-year automatic cost-of-living allowance (COLA) adjustment is linked directly to the average percentage change in the consumer price index (CPI) over the last six months compared with the preceding six months. Thus, the total wage automatically increases in line with the consumer price index excluding excise taxes. Collective agreements contain a cost-of-living allowance as part of the wage. According to the Central Bank of Cyprus, the share of employees receiving a COLA is about 60-65% (those covered by collective agreements). In the wider public sector and in the banking sector almost all workers receive a COLA. In the remaining private sector (excluding banking sector) coverage is much lower, around 30-35%. The uniform application of the COLA introduces an element of real wage rigidity which may hamper the adjustment to supply and terms of trade shocks and that limits the ability of wages to reflect productivity growth differences across economic sectors. COLA also has a significant impact on public finances as, beyond wages and salaries, it is also an integral feature of pensions, benefits and other allowances. Second-round inflationary effects also linked to recurrent supply side shocks may erode competitiveness over time thus contributing to external imbalances. Downward wage and price flexibility is particularly important given the lack of nominal exchange rate flexibility within the monetary union.

As part of an ambitious fiscal consolidation effort to achieve the correction of the widened government fiscal deficit by 2012, the Cypriot government has undertaken a temporary suspension of COLA in the broader public sector including pensioners. Anecdotal evidence suggests that a temporary de-activation of the COLA system is occurring also in the private sector, though this is at the discretion of each employer. In parallel, the government and social partners have agreed to initiate a dialogue with the aim of reviewing the COLA system by mid-2012. This also forms part of the efforts of the national authorities to address

the Council Specific Recommendation of July 2011⁶ requiring Cyprus to take steps to reform the system of wage bargaining and wage indexation to ensure that wage growth better reflects developments in labour productivity and competitiveness. It is important to note that any developments affecting wage developments in the Cypriot public sector (public wage bill almost at 15% of GDP, the highest level in the EU) could act as an anchor for wage developments in the private sector.

3.2.3. *Export performance*

As noted above, in recent years, export-oriented services other than tourism have been gaining ground. During the last decade, the growth of the tourism sector was sluggish due to a loss of competitiveness and increased competition from, *inter alia*, low-cost neighbouring Mediterranean countries. However, overall, the services balance remained rather stable thanks to an improved performance of other export-oriented services, in particular services such as insurance, banking and financial services, merchandise, shipping, and ICT services, which recorded significant growth. The harmonisation process in the run-up to EU-accession (2004) and, later, to euro-area accession (2008) acted as a catalyst in this respect through the liberalisation of various sectors of the Cypriot economy, leading to strengthened competition, and flexibility and confidence.

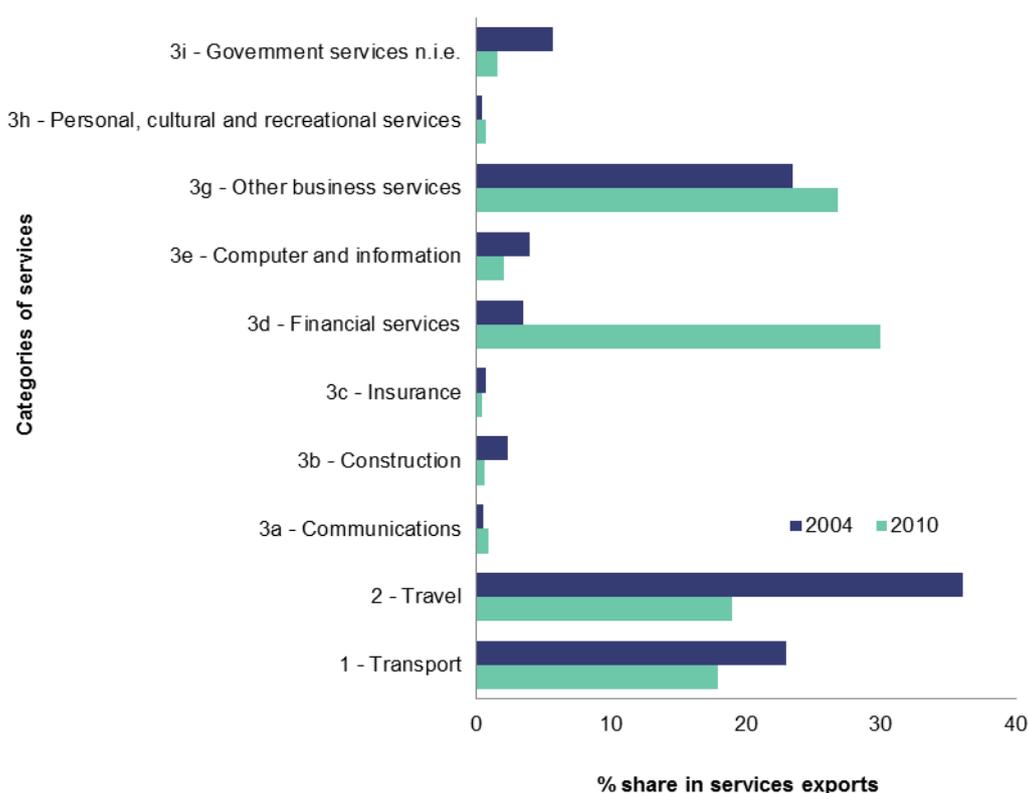
In contrast, while many other euro-area countries were able to take advantage of growing niche markets or quality-enhancing processes for goods, the Cypriot manufacturing sector shrank. The main factors behind this gradual decline were the lack of investment in R&D, innovation, and modern productive and distribution processes, which impacted negatively on productivity growth. Moreover, rising production costs also contributed to the gradual decline of the Cypriot manufacturing sector. The combination of high wage and low productivity growth led to a profit squeeze in the manufacturing sector, as reflected in the downward trend in the ratio of the gross operating surplus to value added over the past few years.

Consistent with the orientation of the Cypriot economy towards the tertiary sector, the export intensity of services reached almost 55% in 2010, compared with 23% in the euro area as a whole. More specifically, exports of services accounted for 83½% of total exports. Export-oriented services have benefited from the country's abundant endowment of skilled labour, a good institutional infrastructure, and the country's strategic geographic location. The expansion of services has also benefited from Cyprus's low corporate tax rates and double tax-treaties, which attracted international offshore companies, creating a demand for local and accounting services. Additionally, demand for vacation homes by foreigners has led to a boom in real-estate-related services in the run-up to the crisis.

Financial and other business services account for 47% (2009) of the total export of services, with transportation and travel services (tourism) accounting for 23% and 22% respectively. This reflects a massive increase in the importance of financial services to Cypriot service exports following membership of the EU.

⁶ Council Recommendation of 12 July 2011 on the national reform programme 2011 for Cyprus and delivering a Council opinion on the updated stability programme of Cyprus, 2011- 2014, Official Journal of the European Communities, C210/12, 16.07.2011.

Graph 10: Sectoral shares in total exports of services, 2004 and 2010



Source: Commission services

Tourism accounts for more than 10% of GDP and around 20% of employment⁷ but was amongst the sectors most affected by the credit squeeze in 2009. Whilst 2011 shows a recovery of tourist arrivals in Cyprus, this trend has nonetheless been declining since its peak in 2010 due in part to the rise of increased price-competition from other Mediterranean countries. Statistics suggest that the current political tensions in part of the Mediterranean may be leading tourists to choose Cyprus as a substitute destination. Yet despite the current, probably temporary, competitive edge over alternative nearby tourist destinations, Cyprus is having difficulties returning to its 2008 peak for numbers of tourists. In addition, allowing for inflation, revenue per tourist visiting Cyprus remains in real terms some way below the pre-crisis period. By the end of the 1980s, receipts from tourism had exceeded 20% of GDP and arrivals had reached 2.5 times the size of the population. The sector stabilized in the 1990s, with the exception of a temporary disruption caused by the 1991 Gulf War. It began to show some signs of decline in the later part of the decade but rebounded around 2000. This proved to be a brief reprieve, however, as the sector exhibited a sharp decline in both receipts and arrivals in the last several years. Receipts in 2007 were 12.1% of GDP while arrivals have hovered around 2.4 million visitors.

Cyprus now struggles to position itself in the international tourism landscape. The World Economic Forum (WEF) ranks Cyprus 109th in the world with respect to the price competitiveness of its travel and tourism industry. Factors that may have led to this development include the constraints in the existing capacity of the tourism infrastructure in accommodating the growing number of tourism inflows, as well as the loss of the domestic character of the services offered (an increasing employment of foreigners in this industry who

⁷ SPI database, Commission services: <http://www.ecfin.cec/directorates/db/u2/database%20spi/spi.htm>

do not speak the country's language). Worth mentioning is also the fact that, before Cyprus's EU accession, the tourism sector -as a major sector contributing to growth- enjoyed state subsidies or certain tax exemptions, which ceased to exist after EU membership. In an aim to boost the sector, the government recently adopted strategic plans for attracting more tourists (ex. plans for the introduction of new destinations, for tourist traffic growth, and incentive schemes for winter tourism). Also, the adopted tourism strategy for the period 2011-2015 aims at upgrading the non-price competitiveness of the tourist-product in order to attract high quality tourism and could provide measures to promote the development of a modern sustainable tourism (e.g. construction of marinas, golf courses, infrastructure/marketing of sport tourism).

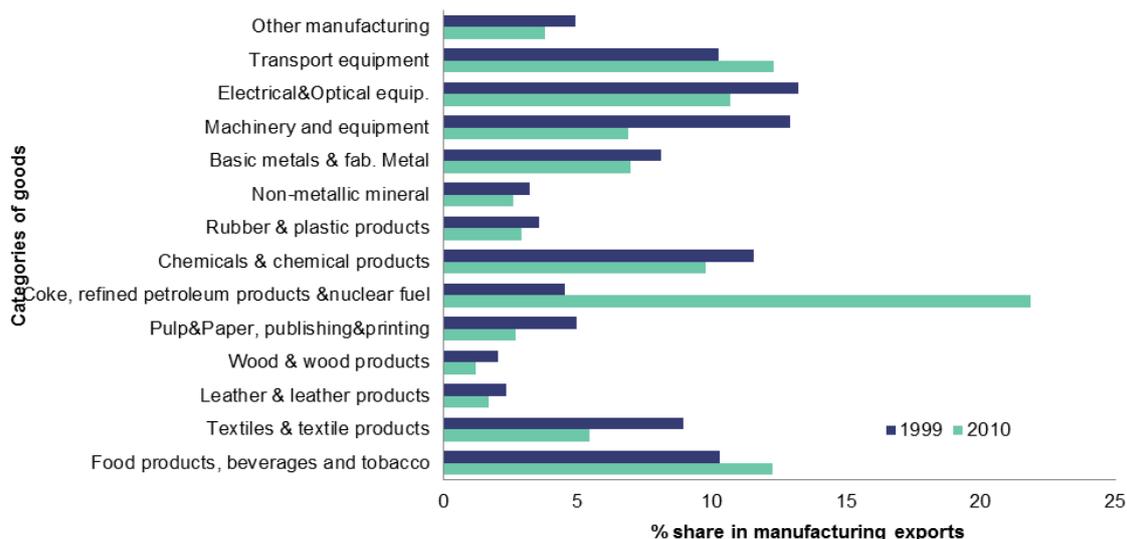
The drop in Cyprus' exports at the peak of the crisis in 2009 was mild compared with other euro-area countries, as was their recovery in 2010, most likely due to lower reliance on manufacturing exports. Although tourism declines substantially, exports of other services (transport, financial, and business) were relatively sustained well during the downturn in 2009. At the same time, exports across all sectors saw only a weak recovery in 2010. This largely mirrors the fact that countries that have a relatively high service share in total exports tend to be less sensitive to external demand volatility.

Where manufacturing trade is concerned, the degree of trade openness (imports plus exports as a % of GDP) Cyprus is high, reaching about 100% of GDP in 2010. The EU is reinforcing its position as the country's main trading partner. In 2010, the share of intra-EU exports in total exports of goods was about 66.25% (up from about 58% in 1999, the first year for which data exist), which is comparable to the share of intra-EU imports of goods in total imports.

From a geographical perspective, the major partner of Cyprus for trade of goods is the EU (Greece, Germany, the UK and Italy) followed by Near and Middle Eastern countries (Israel, United Arab Emirates, Lebanon), and other Asian countries. The leading markets for Cyprus' services exports are the Russian Federation (26%), the UK (20%), and Greece (11%), followed by the CIS and NAFTA countries. While the UK and Germany have traditionally been the main destinations for Cypriot service exports, the Russian Federation has rapidly gained importance in recent years, and now claims the largest market share.

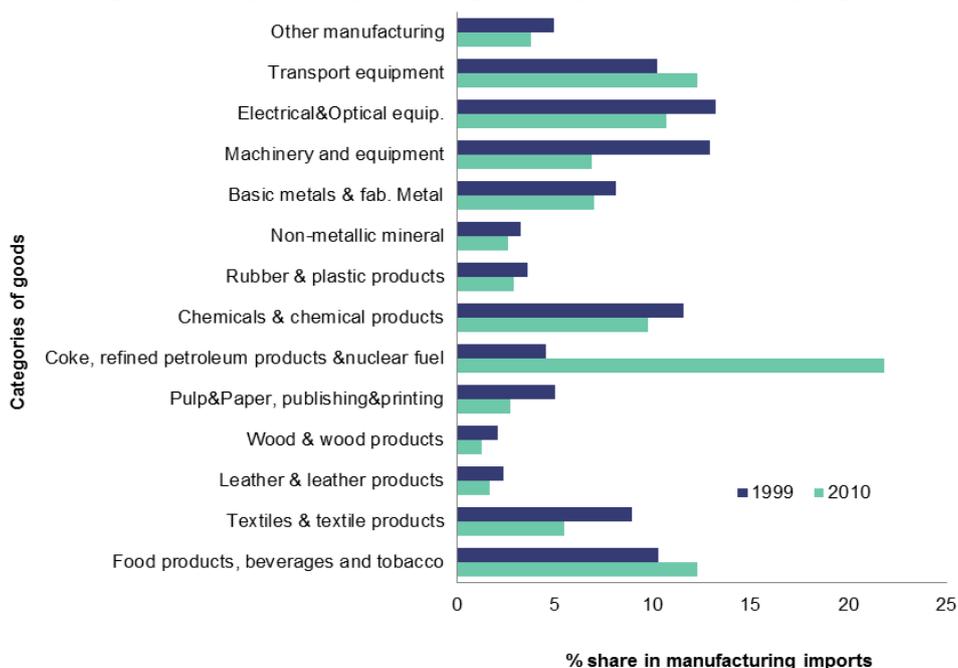
Cyprus' most successful manufacturing exports currently are pharmaceuticals and photosensitive semiconductor devices, which accounted for 22½% and 12% respectively of domestic exports in 2009. The broad evolution of Cyprus' export structure can be seen in Graph 11. In addition, the share of intra-industry trade in total manufacturing with the EU remains among the lowest among Member States. Meanwhile, on the import side, the increase in the price of fuel seems to have substantially increased the importance of refined petroleum products within Cyprus' import mix of manufacturing products. Clearly, Cyprus seems to be very vulnerable to oil price volatility and this may call for the development of a long-run strategy to reduce the country's oil dependency.

Graph 11: Categories of goods as a percentage of manufacturing exports



Source: Commission services

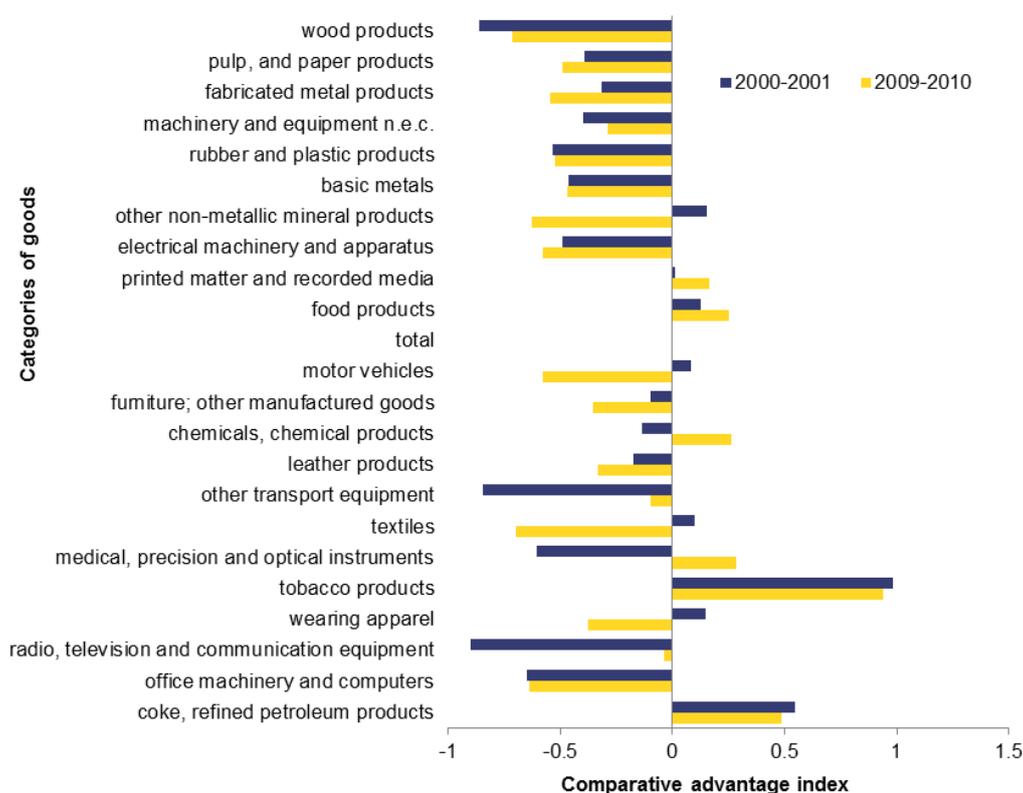
Graph 12: Categories of goods as a percentage of manufacturing imports



Source: Commission services

However, as Graph 13 shows, in spite of the recent dynamic increase in the share of Cypriot exports of pharmaceuticals and photosensitive semiconductor devices, Cyprus' revealed comparative advantage is concentrated in low- and medium-to-low technology sectors, namely food, beverages and tobacco.

Graph 13: Trade in goods: symmetric revealed comparative advantage index - Cyprus



Source: Commission services

As noted above, the goods trade balance has been persistently negative at over 20% of GDP since the late 1990's, reflecting the steady erosion of market shares. While many countries in Southern Europe have been facing losses in export market shares due to deteriorating competitiveness upon joining the EU, the pace of loss for Cyprus has been amongst the fastest. At the same time, the market share of service exports has been largely constant, with a decline in 2008-2009, when Cypriot exports contracted less than elsewhere in the world.

4. INTERNAL POSITIONS AND THEIR SUSTAINABILITY

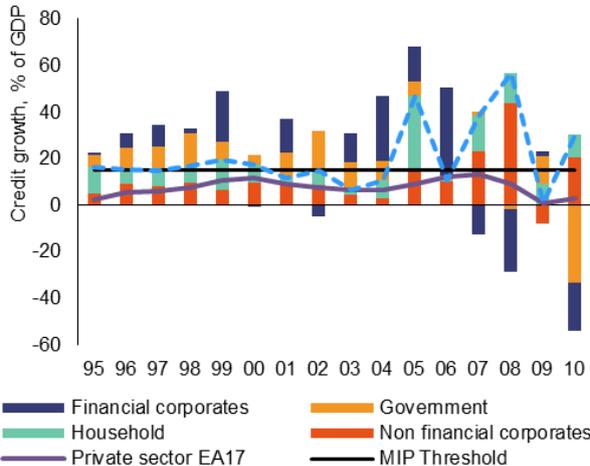
4.1. Private sector indebtedness

The Cypriot private sector is considerably leveraged. The total private indebtedness (as a share of GDP) in Cyprus is the second highest in EU, with debt of non-financial corporations being the one that stands out. While household debt seems to be well covered by positive net financial assets, corporate debt is of greater concern. Notably, profits are squeezed by slackening domestic demand and by tighter financing conditions, as domestic banks struggle with a rising number of non-performing loans and the need for recapitalisation.

Private sector debt continued to rise in Cyprus in 2010. A snapshot at the credit flow developments illustrates that Cyprus is the only Member State exhibiting high credit growth in 2010 and thus breaching the corresponding MIP threshold (Graph 14). Together with the second highest private sector leverage ratio in the EU after Ireland (Graph 15), this points to a further built-up of debt overhang, which can only delay deleveraging - with serious adverse

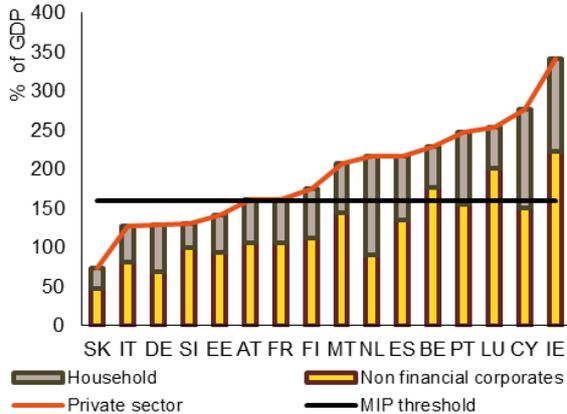
consequences for the economy. Nevertheless Cyprus' currency and deposits are the households sector's most important asset, and also the highest in the EU, as a % of GDP, in both consolidated and non-consolidated figures.

Graph 14: Decomposition of credit growth, as % of GDP



Source: Commission services

Graph 15: Private sector leverage ratios as % of GDP

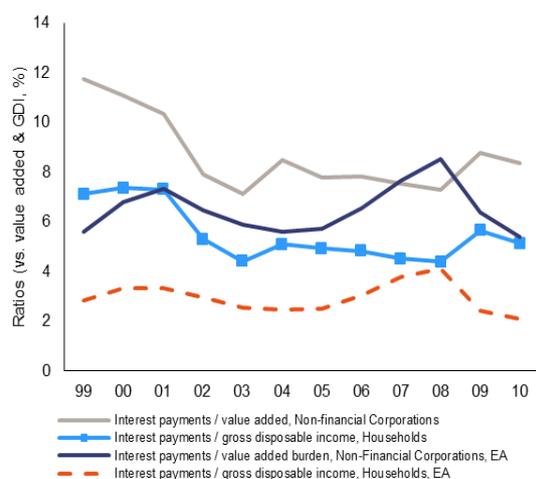


Source: Commission services

4.1.1. Household indebtedness

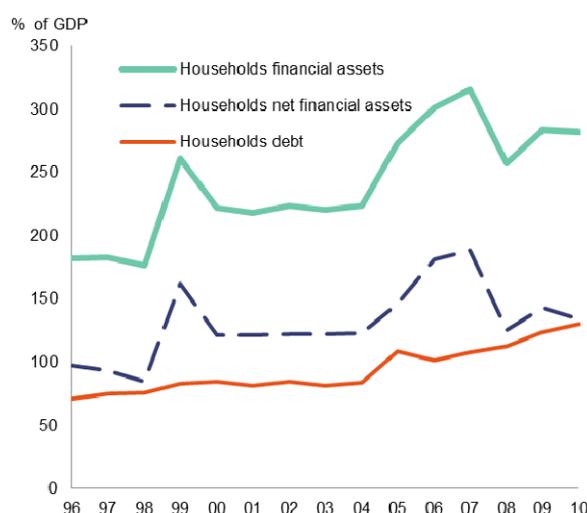
Cyprus has the second highest household debt as a percent of GDP in the EU and the highest in the euro area, but this is covered by substantial assets. Although the high level of household debt exceeds the MIP scoreboard threshold, it should also be noted that households hold substantial assets leading to a positive net asset position. Nevertheless, a high stock of debt increases the vulnerability of the private sector to business cycle fluctuations, inflation and interest rate increases. Evidence shows that countries with a highly leveraged private sector and strong credit growth suffer relatively more in the event of crises. Although the share of interest payments to the disposable income in Cyprus for households is the second highest in the euro area, this is very close to the euro area average (Graph 16), indicating comparable burden of interest payments to households in Cyprus and in the euro area.

Graph 16: Interest payments by households and non-profit institutions serving households (% of disposable income)



Source: Commission services

Graph 17: Household net assets (% of GDP)



Source: Commission services

Households have seen their debt increasing, while their net financial position remains positive, providing a significant cushion against liabilities. The total household debt⁸, as a ratio of residents' bank loans to GDP, has been well above 100% in the last few years, reaching 130% in 2010 and 135% at the end of September 2011 (Graphs 17 and 18). Despite the current crisis, household deposits continued to increase and residents' net financial assets remained positive with the deposit-to-loan ratio at 151% at the end of March 2011, a significant cushion against liabilities. Although the sector's aggregated view does not reveal to what extent deposit-holders are identical with loan-takers, information from the Central Bank of Cyprus shows that almost 90% of households having loans also have deposits and financial assets. This reflects Cypriot households' **tendency to have loans and deposits simultaneously, as a means of security against times of hardship.** This is driven by household reactions on the political insecurity, macroeconomic uncertainty, the inadequate and non-universal healthcare coverage and acute bequest motive (high savings for children).

Household debt mainly takes the form of loans that are well collateralized. According to the Central Bank of Cyprus, more than 75% of total household loans are taken out for the purchase of a main residence, while around 15% are for another real estate asset or for renovation of the main residence. Housing loans in Cyprus account for more than 70% of GDP, the highest share in the euro area where the average is 40%. **Home ownership is at very high levels in Cyprus compared with the euro area.** Specifically, almost 75% of the population in Cyprus own main residence, higher than the average Graph for the euro area. This ratio has been stable over the last few years. As a means of enhancing risk management, the Central Bank of Cyprus has enforced the conditionality of the loans by requiring that they should cover not more than 80% of the value of the primary or first house and not more than 70% of the value of the secondary house. For some time (from July 2007 to end of May 2008) the Central Bank – reacting to a possible risk of excessive household demand and supply of loans set the maximum amount of financing for the secondary market at 60% of the value of the immovable property. The housing loans extended to Cypriots being well collateralized to the value of the immovable property, hedge the risk of banks' exposure to some degree.

⁸

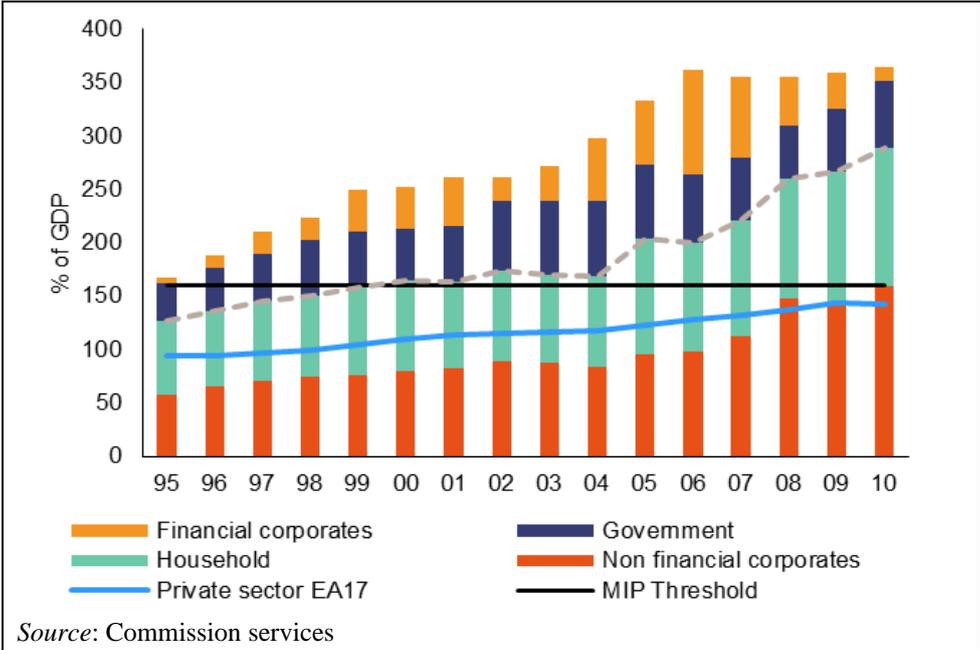
It includes household loans and non-profit institutions servicing households.

Deposits are less liquid in Cyprus than in the rest of the euro area. A substantial part of Cypriot *currency and deposits* falls in the category of “other deposits” (85% of total *currency and deposits* compared with 60% in the rest of the euro area). *Other deposits* are such that they cannot be withdrawn at any time without restriction or penalty and are thus less liquid than transferable deposits and currency. However, even *other deposits* may be withdrawn in times of heightened financial uncertainty. Nevertheless, even under the current adverse macroeconomic conditions, the rate of withdrawal of resident deposits has not been significant.

Non-performing loans, as a percentage of the total loans of Cypriot households seem to be low. Despite the adverse economic conditions, household non-performing loans did not increase significantly. The management of the biggest Cypriot banks does not anticipate any significant increase in their number, since Cypriot household debt is much covered by deposits.

Given the positive net financial position of households, household debt seems to be less of a problem than suggested by the gross debt figures. Nevertheless, it is expected that, due to worsening macroeconomic conditions and the squeeze of disposable income, the net financial assets - acting as a risk management shield for household loans - will continue to fall, as households use some of their deposits for consumption in the short term.

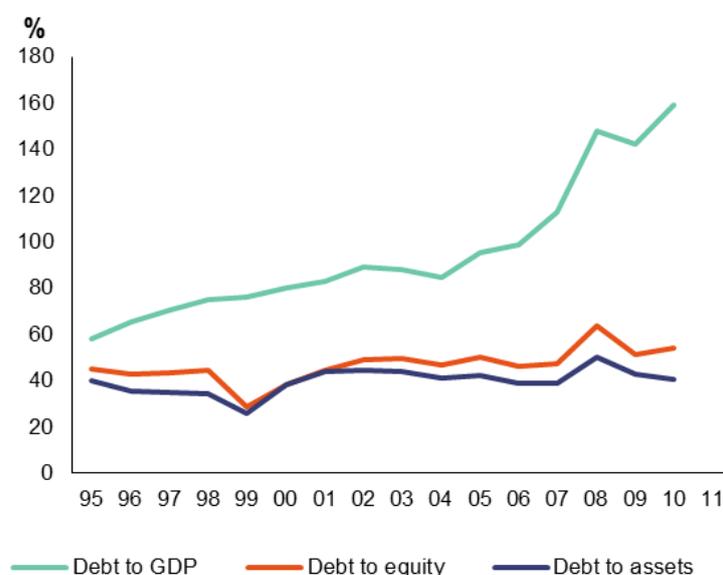
Graph 18: Indebtedness by sector



4.1.2. *Indebtedness of non- financial corporations*

Corporate indebtedness in Cyprus is one of the highest in Europe (Graph 15). Companies are highly indebted, ranking fifth highest in euro area, the ratio of residents' corporate bank loans and securities to GDP was 185% at the end of September 2011, compared to 100% of GDP in 2006. Unlike the household sector, their net financial position of non-financial corporations is negative. Loans account for around 40% of total corporate liabilities and reached 159% of GDP in 2010 and to 141% of GDP at the end of September 2011. The main vulnerabilities of the Cypriot corporate sector derive from weak profits due to the constrained domestic demand, high leverage, and a notable dependence on bank finance.

Graph 19: Leverage ratios of non-financial corporates (% of GDP)



Source: Commission services

Non-financial corporations (NFCs) exhibit a rather stable debt-to-equity and debt-to-assets ratios (Graph 19). A significant increase in the indebtedness of NFCs was observed in 2009, when the financial crisis took its toll on the economy and the profitability of NFCs diminished. The fact that the debt-to-equity ratio and debt-to-assets ratio are stable, despite of the increasing debt, suggests that non-financial corporations are managing to finance themselves and to raise equity and assets at the same levels.

The share of non-performing loans to non-financial corporations has been increasing significantly. Loans to non-financial corporations represent around 47% of total loans to the private sector. At the same time, non-performing loans, as a percentage of total loans, increased significantly from 7.4% in March 2010 to 9.1% in March 2011 and 10.1% in September 2011. The high incidence of non-performing loans is an additional burden on the profitability of Cypriot banks, thereby affecting bank deleveraging. The challenge is to ensure that banks remain solvent in the face of rising non-performing loans from the corporate sector.

Part of the high level of corporate indebtedness in Cyprus may also be attributed to some country particularities. First, the loans by the NFCs are collateralised by corresponding assets, either financial or immovable property, thus the risk attached to them is reduced. Second, according to the Central Bank of Cyprus, in 2010 NFCs assets in Cyprus are equal to 71% of GDP, whereas this ratio is much smaller for the euro area, just 24%. Therefore, the imbalance seems to be contained on a net basis. Third, most NFCs in Cyprus are small enterprises and thus their main source of funding is loans from banks, in contrast to bigger euro-area enterprises which have access to other sources of funding, such as shares and other equity.

The size of corporate indebtedness is very large, the fifth most indebted in the euro area (Graph 15 – Private sector leverage ratios, where comparable information for Greece is not available). The 19% reduction in non-financial corporations' debt between December 2010 and September 2011 seems promising, although the drivers of this reduction are unclear due to a lack of more detailed information. High level of corporate indebtedness could hamper investment and hold back the growth potential of the economy.

4.2. Sustainability of public finances

Public finances in Cyprus deteriorated substantially as a result of the global economic crisis and discretionary fiscal stimulus measures, as well as composition effects due to a less tax-rich GDP growth pattern. Beyond the need for correction of an excessive government deficit, **Cyprus faces challenges in:** (i) reducing the high general government structural deficit and ensuring the long-term sustainability of public finances in view of population ageing and (ii) improving efficiency of public spending and ensuring a reallocation of public expenditure towards growth-enhancing items.

4.2.1. Financing costs

Cyprus has been severely affected by financial contagion from Greece. Ten year bond yields spreads over the German bunds have reached prohibitive levels since end-May 2011 (Graph 20), making access to international markets lending virtually non-existing. Credit-rating agencies have repeatedly downgraded the Cypriot sovereign, culminating in a non-investment grade rating for the Cyprus sovereign (Table 2). The rationale provided for the downgrades highlighted in particular (apart from the fiscal imbalance) the high exposure of the Cyprus' banks to Greek debt, the large size of the Cyprus banking sector and the Cyprus authorities' potential to support domestic banks in case of need.

Table 2: Cyprus' sovereign credit ratings (mid-May 2012)

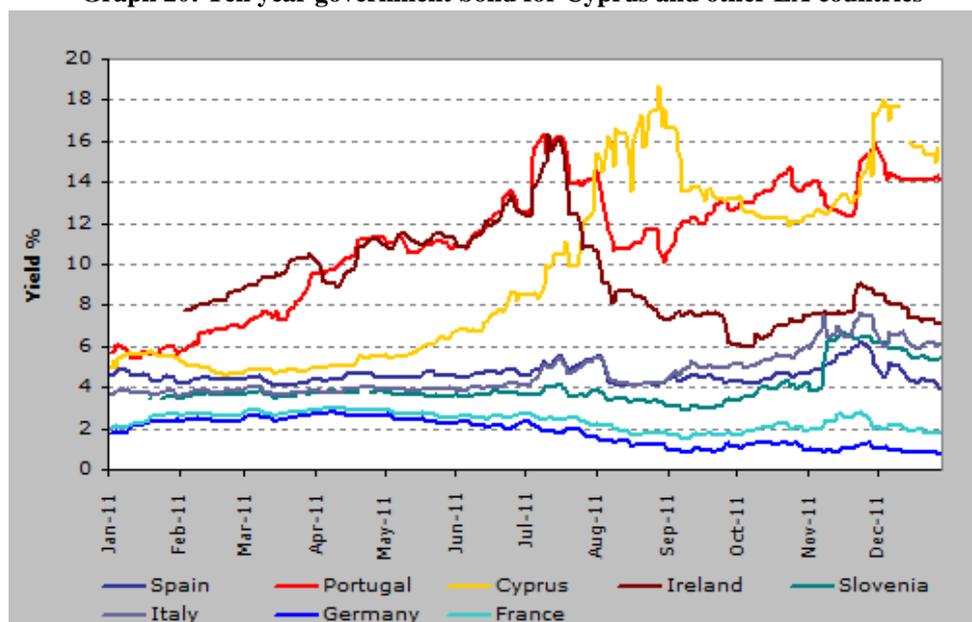
Cyprus long term rating			
	S&P's	Fitch	Moody's
	***BB+ Neg	* BBB- Neg	***Ba1 Neg

* One notch above non-investment grade

*** Non-investment grade

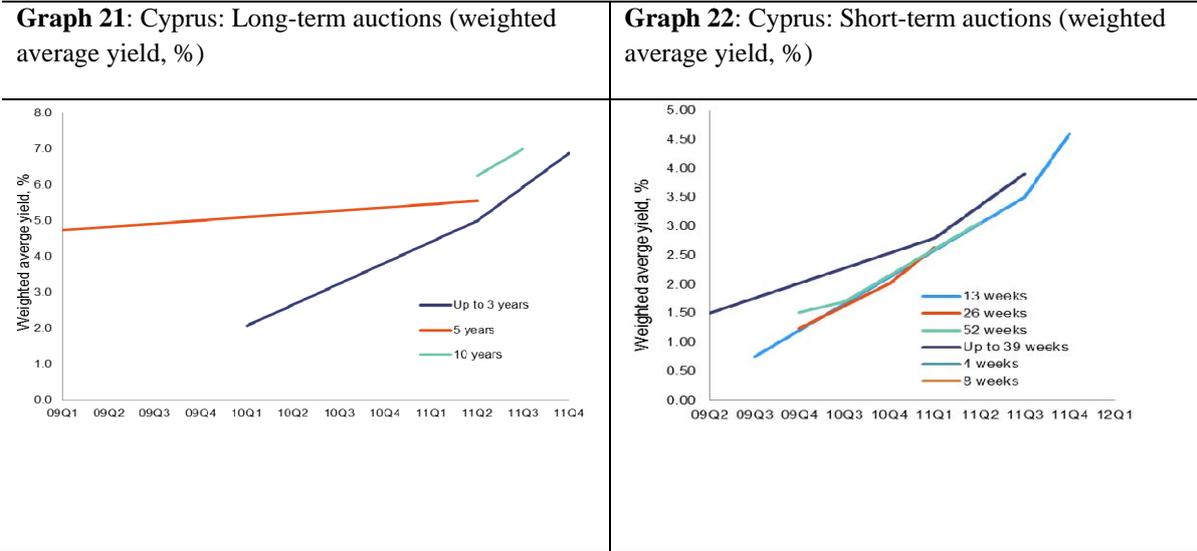
Source: Commission Services

Graph 20: Ten year government bond for Cyprus and other EA countries



Source: Annual Report 2011, Public Debt Management Office, Ministry of Finance

Borrowing costs for Cyprus have been increasing (Graphs 21 and 22), while financing needs are significant in the short-term (Graph 23). Even in the domestic market, the cost of 3-year sovereign financing rose to 6.75% in December 2011 from 5% in April 2011. The last two-months Treasury Bill issued in February 2012 had a yield of 4.50%. The Public Debt Management Office is relying on the domestic market to cover the financing needs for the rest of the year, through the issuance of EUR 0.2 billion in short-term debt and EUR 0.1 billion in three-year bonds.



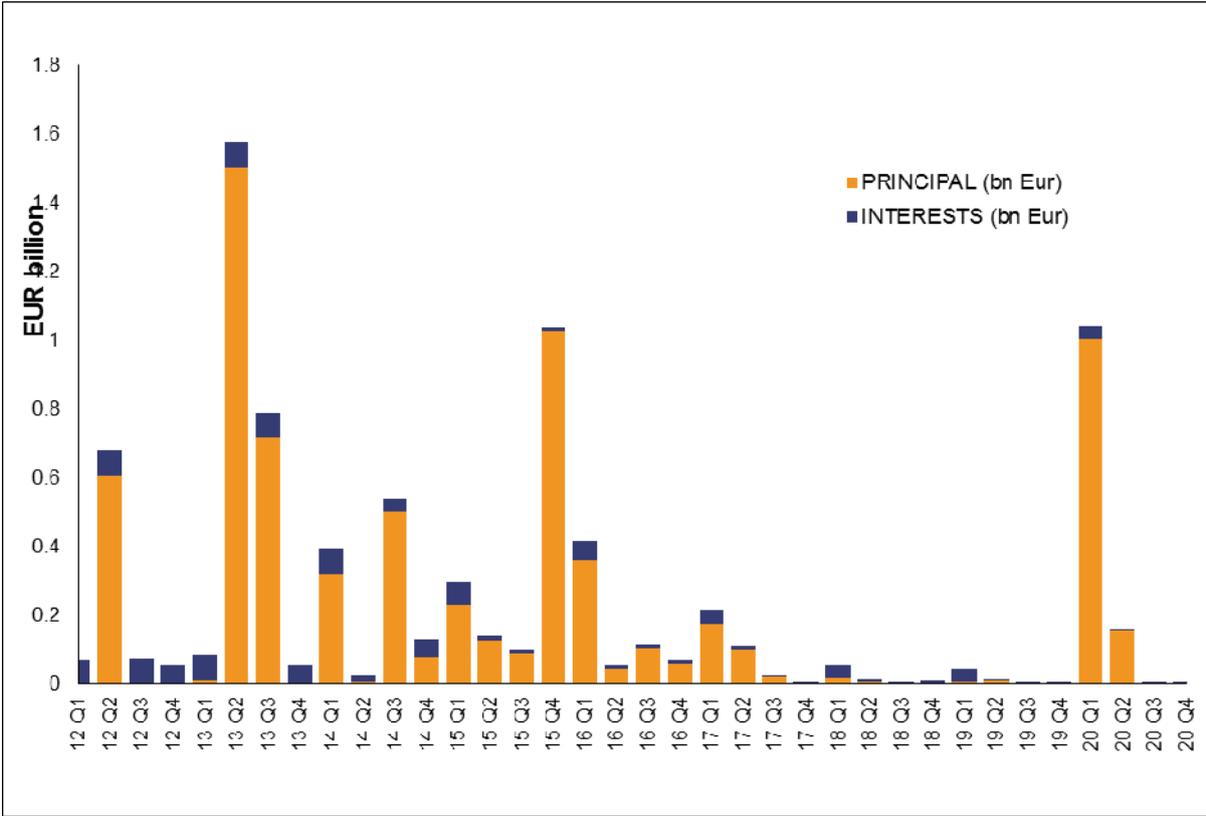
Source: Public Debt Management Office (Ministry of Finance) and ECFIN

4.2.2. Refinancing needs

The downgrading of the Cypriot economy has further complicated borrowing from international markets. In this context, the government signed a bilateral loan agreement with the Russian Federation in December 2011, which will cover most of the government financing needs for 2012 through a loan of €2.5 billion at 4½ % p.a., maturing in 2016.

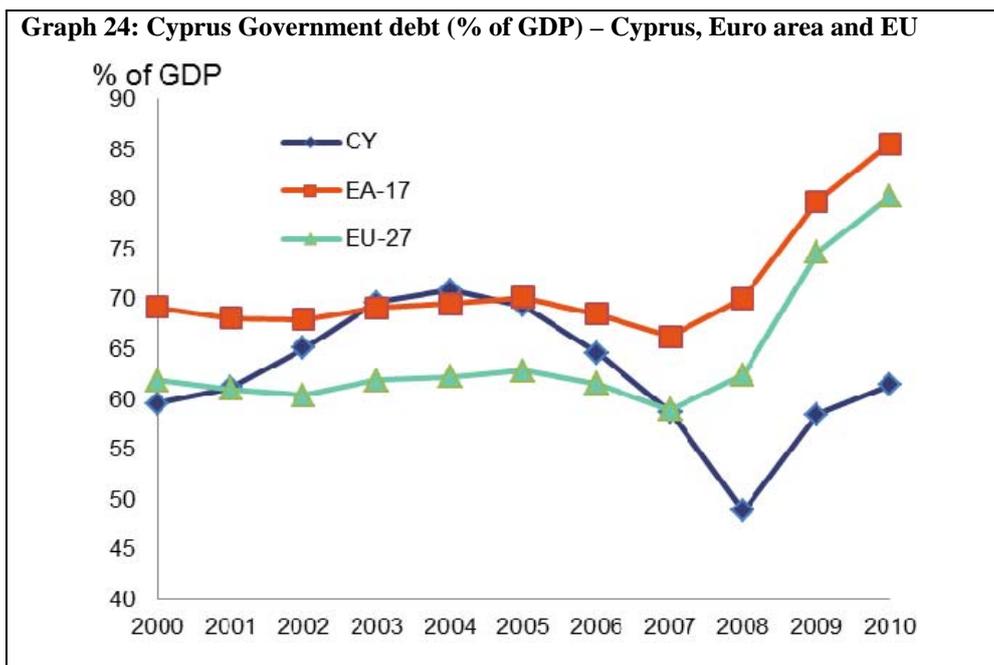
Financing needs for 2013 are also high (Graph 23). They reach to about €3.2 billion (maturing debt and fiscal deficit), not including any bank recapitalisations needs. Nevertheless, most of this debt is roll-over of existing debt from internal investors, particularly the Central Bank of Cyprus and the Central Cooperative Bank. Additionally, bonds maturing in mid- 2014 amount to less than a billion euro. The financing needs for Cyprus thereafter appear to be less acute.

Graph 23: Cyprus sovereign debt maturity and interest, EUR bln, (excl. Russian loan repayment in 2016)



Source: Public Debt Management Office (Ministry of Finance) and ECFIN

Cyprus’ government debt is lower than the euro-area average (Graph 24) but has nevertheless been on a rising trend, reaching 71.6% of GDP in 2011. The rising trend is due to the still-high primary deficits, increasing borrowing rates and the effect of the Russian loan, the first tranche of which was received in December 2011. The rising borrowing rates facing Cyprus are in turn driven by fading market confidence, given the high government deficits and the exposure of the economy to developments in Greece.



Source: Commission services

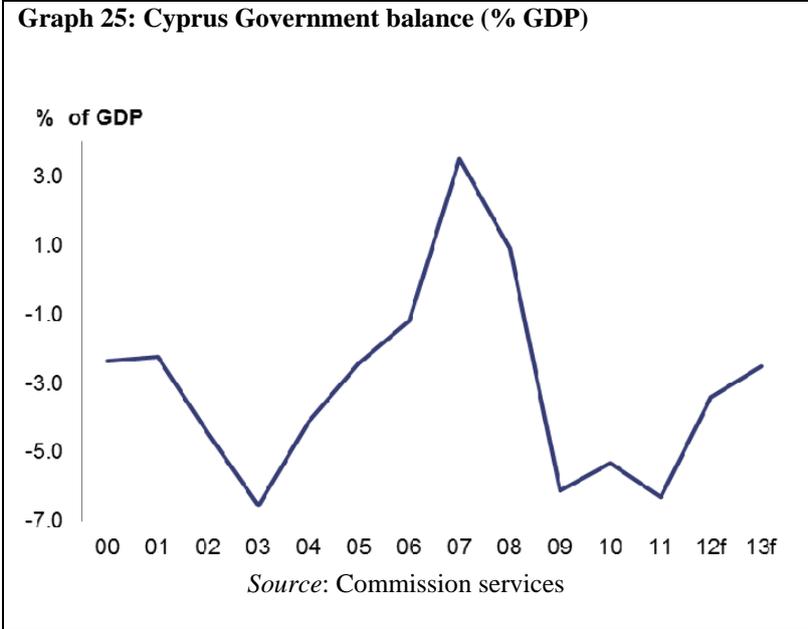
4.2.3. Government deficit

Public finances in Cyprus deteriorated substantially over the last 3 years. The global economic crisis and counter-cyclical policy action to attenuate its impact on the Cypriot economy (in line with European Economy Recovery Plan, EERP), along with a shift in aggregate demand towards less tax-rich components, led to a swing in Cyprus' general government balance from a surplus of 0.9% of GDP in 2008 to a deficit of 6.1% of GDP in 2009 (Graph 25). In parallel, the general government gross debt, which stood at 58% in 2009, increased sharply. Against this background, the Council decided on 13 July 2010 that an excessive deficit existed⁹.

In 2011, the budget deficit widened to 6.3% of GDP from 5.3% in 2010. This is significantly higher than the deficit of 4% of GDP planned in the May 2011 update of the Stability Programme. This deviation is explained mainly by lower-than-expected revenues (2¼ pps. of GDP), despite the rise in VAT on food and pharmaceuticals in the beginning of the year, but also slightly higher expenditures (½ pp.). The revenue shortfall was due to: (i) a slowdown of activity; (ii) reduced corporate profitability; and (iii) the disruption of economic activity following the destruction of the Vassilikos power plant. The changing composition of GDP towards less tax-rich demand components also played a role. At the same time, expenditure slippages appear to be related to rising social outlays due to higher unemployment and redundancy payments, as well as due to the electoral cycle and the higher

⁹ The Council recommended that "the Cypriot authorities should bring the general government deficit below 3% of GDP by 2012 in a credible and sustainable manner by taking action in a medium-term framework. To this end, Cyprus was recommended to: (a) take necessary measures to reduce the 2010 deficit to at most 6% of GDP and define an expenditure-driven consolidation strategy, in order to bring the deficit below the reference value by 2012; (b) to this end ensure an average annual fiscal effort of at least 1½% of GDP in 2011-12, also in order to contribute to bringing the government gross debt ratio back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus; and (c) specify and rigorously implement the measures that are necessary to achieve the correction of the excessive deficit by 2012, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than expected"

cost of financing. With a view to reducing the budget deficit, the government adopted a fiscal consolidation package yielding an estimated annual consolidation impact of about ½ pp. of GDP in 2011-12. This package also included two important structural measures: the payment of contributions by public sector employees to their public pension funds and the inclusion of newcomers in the public sector in the social security fund, together with the abolition of occupational pensions. The structural deficit, measured by the cyclically-adjusted balance net of one-offs, still rose from 5¾% of GDP in 2010 to almost 6% in 2011.



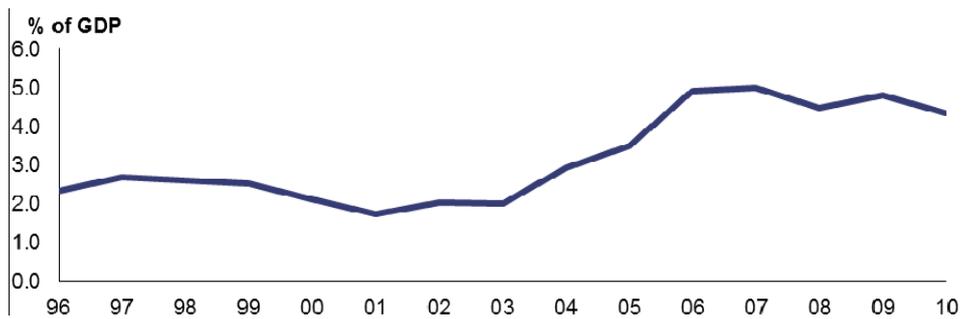
4.3. The housing sector

Starting in 2003, the annual rate of increase in the stock of dwellings accelerated substantially. While the average annual number of newly-completed dwellings stood at 6,500 between 1995 and 2002, this average rose to around 14,700 between 2003 and 2010 and reached a peak of 18,200 in 2008, higher than warranted by the increase in population. Consequently, the stock of dwellings has increased by more than 124,000 units since 2001, i.e. by more than 34% in less than 10 years. To the extent that no shortage of dwellings was identified in 2001, this substantial increase is attributable to real estate investment decisions by residents and foreigners. Following the fixing of the exchange rate of the Cypriot pound to euro in July 2007, at the same exchange rate that prevailed in the Exchange Rate Mechanism II, there was a significant rise in the rate of credit growth. Factors stimulating the housing market boom include the reduced exchange rate risk and the fall in interest rates. These led to very high demand for property by both Cypriots and, mainly, foreign investors, which put upward pressure on house prices.

4.3.1. Volume developments

The stock of dwellings is still increasing but at declining rates. As indicated by Graph 26, the stock of dwellings is still rising, with a small deceleration compared to 2006 rates.

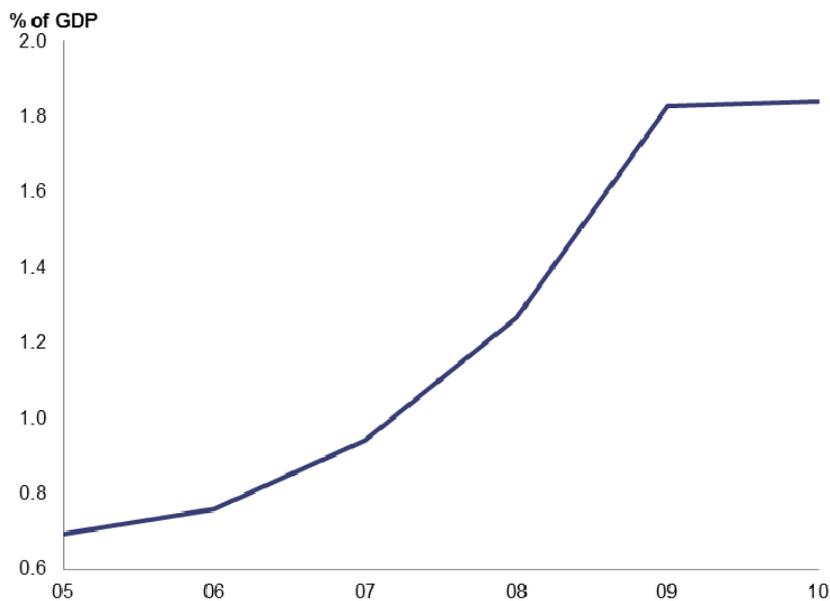
Graph 26: Stock of dwellings (% change)



Source: Department of Land and Surveys, Cyprus

Government involvement in the housing market remains strong. The Special Service for the Care and Rehabilitation of Displaced Persons continues to offer four different housing schemes. In addition, the Cyprus Land Development Corporation offers low-cost building plots to low and medium-income families. Finally, the Housing Finance Corporation provides subsidised long-term housing loans. These represent a substantial portion of the government's current expenditure, as housing policy has become an established element of social welfare policy in Cyprus.

Graph 27: Government housing spending, %GDP



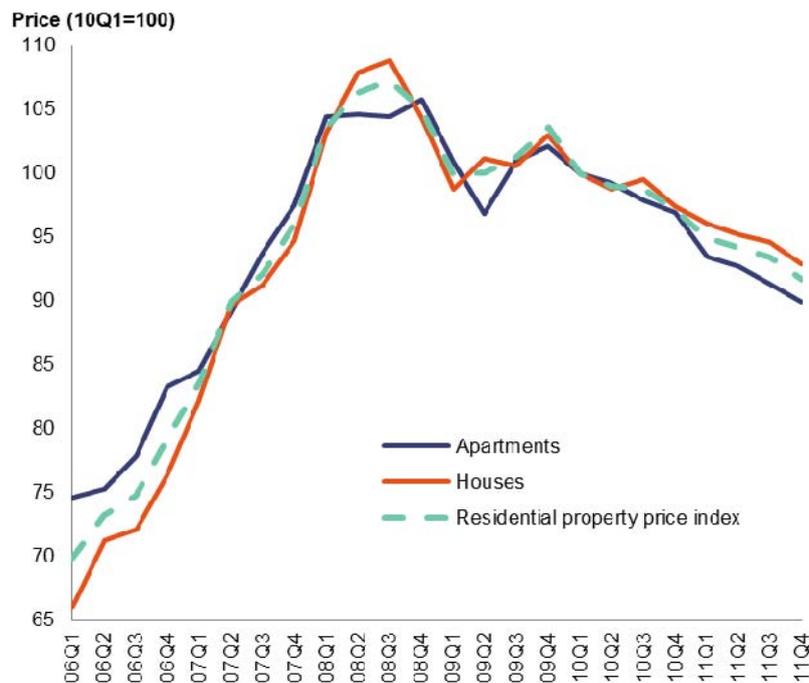
Source: Commission services

Government social transfers for housing purposes have been on a rising trend in the last few years, before flattening in 2010. From 0.7% GDP in 2005 they grew to 1.8% GDP in 2009. Even though the increase in government spending for housing has been significant, this is not the main driver of the housing market in Cyprus, as it seems obvious that the mainly foreign property investors in particular put upward pressure on the demand for immovable property, as discussed below.

4.3.2. Price developments

Property prices in Cyprus increased significantly from 2006¹⁰ onwards, reaching a peak in mid-2008 (Graph 28). Since then, a correction has been taking place at a slow rate. Prices were driven by strong external demand for housing in the years 2006 to 2008. The adjustment of prices is rather gradual, due to the comfortable household position in terms of deposits. This puts less pressure on property owners to sell, since they can afford to wait in anticipation of future price rises.

Graph 28: House and apartment price indices (2010Q1=100)

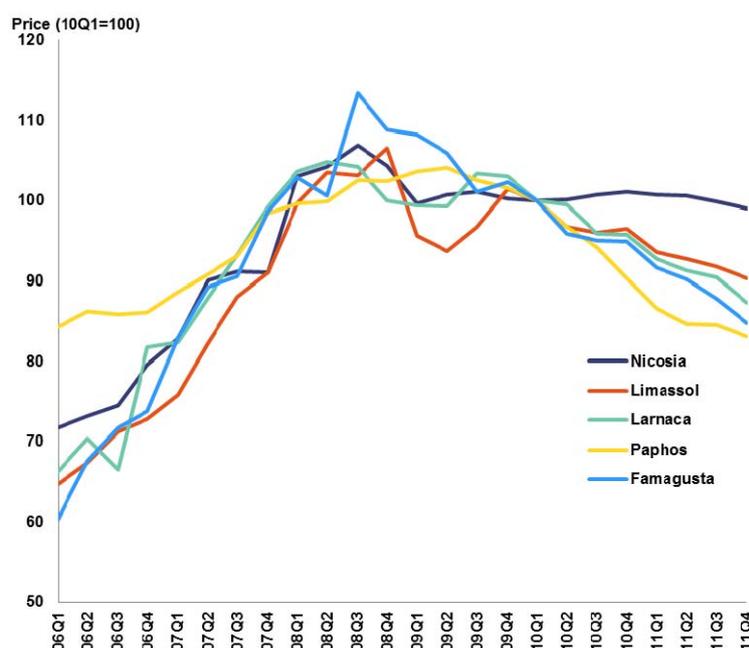


Source: Central Bank of Cyprus

Graph 29 suggests that despite the price adjustment in the construction sector in Cyprus as a whole, this was not distributed equally across the regions of the country: there is little evidence of a price adjustment in Nicosia and Limassol, compared to a slight correction in coastal areas.

¹⁰ Data unavailability on property prices prior to end 2005 makes the start of the price rally difficult to identify.

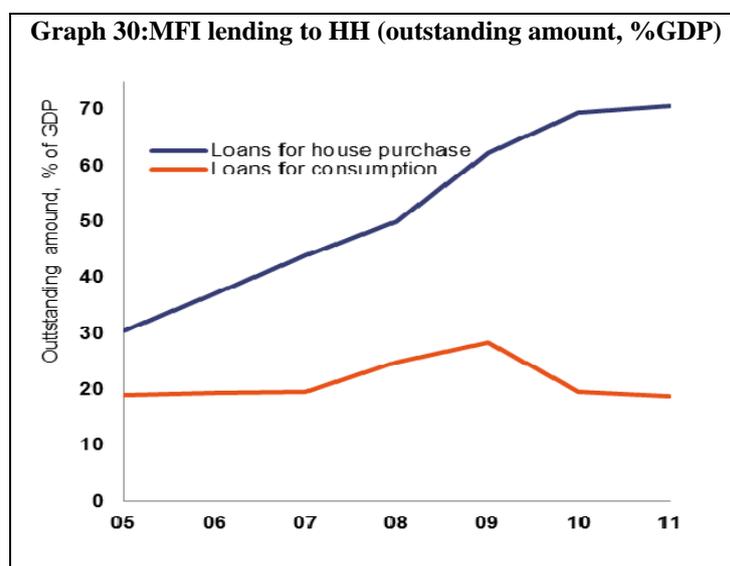
Graph 29: Prices of residences by district (2010Q1=100, %change)



Source: Central Bank of Cyprus

4.3.3. Relevance for private indebtedness

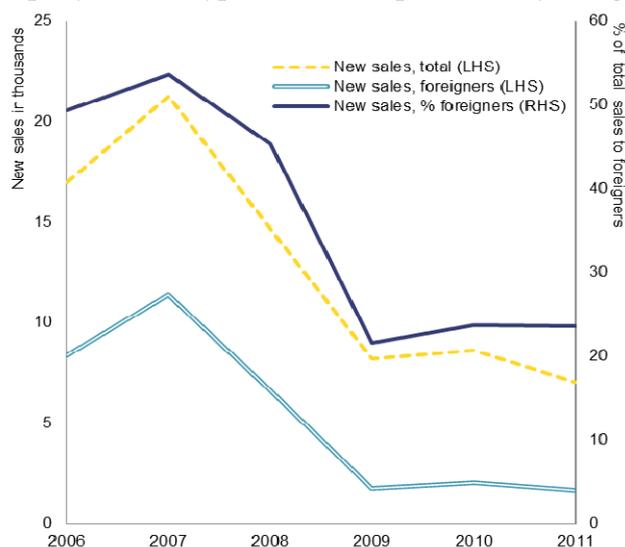
Mortgage loans to households are characterised by a persistent rising trend (Graph 30). This trend, which is reflected in a high degree of household indebtedness in Cyprus, suggests an imbalance that was driven housing market developments in Cyprus, even though the value of the corresponding indicator for house prices did not breach the threshold set in the MIP scoreboard.



Source: Commission services

An analysis of developments in the housing market in Cyprus suggests that these have been driven mainly by external demand for housing. As shown in Graph 31, between 2005 and 2007, about half of the new property sales in Cyprus were made to foreigners. This is considered to be the major driver of the increase in housing market sales during this period. Since 2008, the proportion has remained stable at about 20% of total new sales.

Graph 31: Total new property sales in Cyprus and share purchased by foreigners, as % of total sales



Source: Department of Land and Surveys, Cyprus

The boom in the real estate sector was supported by strong credit expansion, which significantly increased the exposure of banks to developments in the real estate sector. Loans to households for housing increased from EUR 4.1 billion in January 2006 to EUR 12 billion in May 2011, with their relative share in total bank loans to households growing from 33.1% to 53.3%. Financing by banks of the domestic real estate sector, excluding loans to households, was very high at 20.6% of total loans to domestic residents at end-September 2010. Together with loans to households for house purchase, the total exposure of banks to real estate and housing reached EUR 21.3 billion, or 35.7% of their total loan portfolio. Within the sub-category of loans to non-financial corporations, the financing of real estate activities stood at 44% of the total at end-September 2010.

The property market in Cyprus is affected by a title-deeds problem. For a number of administrative and regulatory reasons, between 120,000 and 130,000 properties are currently lacking title deeds. The average time for obtaining a title deed is just under 12 years and more than 200,000 owners are affected by this. The title deeds problem is a significant impediment to concluding transactions in the housing market.

4.4. The banking sector

The Cypriot banking sector is large in size relative to the economy's annual output. The Cypriot financial sector consists almost exclusively of banks, which are the dominant financial intermediaries in the country. With total consolidated assets amounting to 750% of GDP, the banking sector is large relative to the size of the economy. In terms of relative size, it is more than double the euro-area average, which may give rise to some risks to financial stability in Cyprus. Where banking assets as percentage of national GDP is concerned, Cyprus ranks fourth in the euro area, after Luxembourg (2447% of GDP), Ireland (817% of GDP) and Malta (777% GDP). This would imply a significant challenge in terms of government support should the banking system require financial assistance.

The banking system in Cyprus comprises two main segments. The domestically supervised segment includes banks with total assets of EUR 99.5 billion, cooperative societies with total assets of EUR 17.1 billion and foreign subsidiaries, mainly of Greek banks, with total assets of EUR 26.5 billion at end-December 2011. The second segment of the banking system is made up of banking institutions that are subject to home (foreign) supervision,

notably bank branches and two subsidiaries of a foreign-owned government-controlled bank. These institutions hold a total of EUR 20.2 billion of assets. Total consolidated assets of banks in Cyprus, including their foreign operations, amount to EUR 146 billion, i.e. 814% of GDP in 2011.

Table 3: Assets of the largest domestic banks in Cyprus

	Assets	Market share	Assets
Banks on the Cyprus Stock Exchange	in EUR billion	in % total assets	in % of GDP
Bank of Cyprus	37.835	28.2	211.0
Cyprus Popular Bank	34.077	25.4	190.1
Hellenic Bank	8.279	6.2	46.2
Total	80.191	59.8	447.3

Source: Financial Reports of the respective MFIs.

A large part of the Cypriot banking system is concentrated within three major domestic banks. The two dominant domestic banks in terms of assets are Bank of Cyprus and Cyprus Popular (Laiki) Bank¹¹ (Table 3), with holdings of EUR 38 billion (211% of GDP) and EUR 34 billion (190% GDP), respectively. These are also the largest in terms of deposits, notably Bank of Cyprus with EUR 19.4 billion deposits (108% of GDP), Cyprus Popular (Laiki) Bank with EUR 11.7 billion deposits (65% of GDP) and the Hellenic Bank with 6.5 billion deposits (36% of GDP). Altogether, these three institutions claim a market share of 54.3% of all deposits, which makes the Cypriot banking system rather concentrated.

The credit ratings of Cypriot banks have been downgraded further due to pressures from developments in Greece and the Cypriot sovereign downgrades (Graph 33), thus making it more difficult for them to raise capital through the markets. The latest downgrade of the three domestic banks came from Moody's on 14 March 2012 following a sovereign downgrade a day earlier. Bank of Cyprus was downgraded by two notches to B1 from Ba2¹² and Cyprus Popular (Laiki) Bank to B3 from B2. Both banks are non-investment grade according to Moody's. The main reason given for the rating cuts was the losses on banks' holdings of Greek government bonds after the Greek debt exchange.

¹¹ Cyprus Popular (Laiki) Bank's former name was Marfin Laiki Bank.

¹² Below the sovereign rating which was downgraded to Ba1 from Baa3.

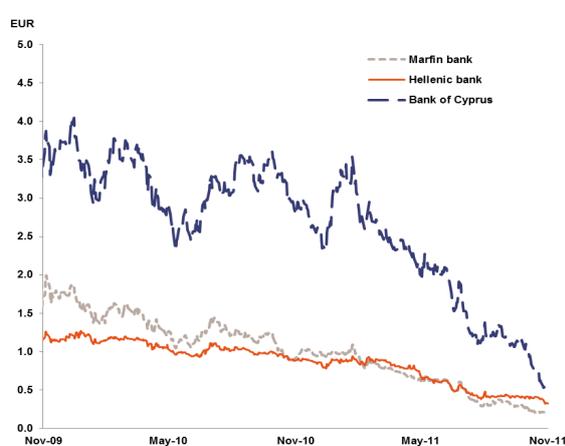
Table 4: Soundness and performance indicators for Cyprus largest banks (Bank of Cyprus and Marfin)

	2008		2009		2010		2011	
	in EUR billion		Bank of Cyprus	Cyprus Popular Bank	Bank of Cyprus	Cyprus Popular Bank	Bank of Cyprus	Cyprus Popular Bank
Total assets	36.131	38.367	39.411	41.828	42.638	42.580	37.835	34.077
Net interest income	0.792	0.744	0.848	0.636	1.040	0.710	1.168	0.799
Profit/loss after tax and GGBs impairments	0.502	0.092	0.313	0.187	0.306	0.095	-1.011	-2.514
Risk weighted assets*	21.179	21.813	24.065	25.622	26.277	27.627	26.493	28.400
	as %							
Cost/income ratio*	45.8	54.5	52.4	58.1	50	63.8	48.9	62.6
Return on equity (RoE)	25.1	18.3	14	7.7	11.9	3.8	11.2	3.3
Core Tier 1 ratio				8	8.1	7	5.1	n.a.
Tier 1 ratio	7.2	8.6	8.8	9.1	11	10.0	8.9	n.a.
CAR ratio	11.2	10.6	11.7	11.5	11.9	11.6	9.2	n.a.
Loans to deposits (LTD)	87.4	94.4	89.7	105.0	84.1	104.0	97.4	122.9
Non-performing loans to total gross loans (NPL)	3.8	4.3	5.6	6.1	7.3	7.3	10.2	13.9
Bank provisions to NPLs (Coverage ratio)		61.0	59	51.0	55	51.0	54	47.0

*Latest available data for June 2011

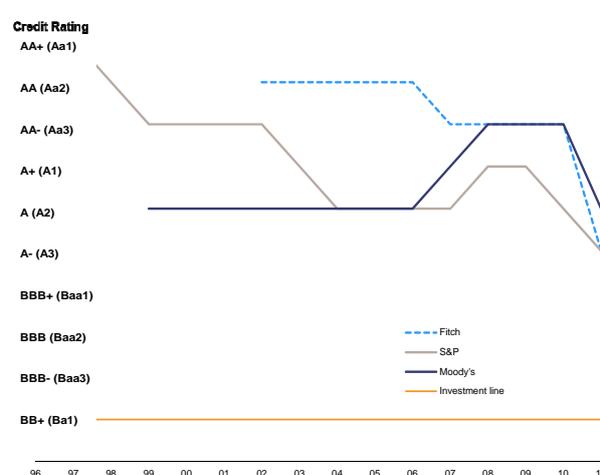
Source: Annual and quarterly reports of reporting banks

Graph 32: Stock prices of Cypriot biggest banks



Source: Ecwin

Graph 33: Credit ratings of Cypriot biggest banks



Source: Ecwin

In addition, non-performing loans are expected to increase, due to the banks' large loan exposure to both Greece and Cyprus in an unfavourable economic environment. Furthermore, banks are likely to be exposed to challenges to sustain their current funding and liquidity profiles, while some deposit outflows were already recorded in 2011.

4.4.1. Recapitalisation needs

As a result of large losses on Greek government bond holdings, Cypriot banks' solvency ratios fell below the required supervisory levels and this needs to be addressed in order to reach the EBA targeted minimum of Core Tier 1 of 9% by June 2012, with one main

bank needing government intervention to meet its recapitalisation needs. A further deterioration in asset quality and increasing provisioning undermined the profitability of banks in 2011 and this is expected to remain under pressure due to the weak economic environment in Cyprus and Greece. Anticipating that the Cyprus Popular Bank may fail to achieve its own plan to raise the fresh capital required by mid-June 2012, the government decided to recapitalise the bank and underwrote a rights issue of EUR 1.8 billion on 17 May 2012. In that case, the bank will have to undergo appropriate restructuring and downsizing in line with EU competition law.

Solvency coefficients for the local Cypriot banks fell below regulatory levels due to the haircuts on Greek government bonds and increasing non-performing loans. Following substantial impairments in the nominal values of the Greek government bonds, the capitalisation levels of Cypriot banks were significantly reduced. Given the 9% Core Tier 1 EBA requirement, this implies a substantial capital shortfall for the domestically supervised institutions. To this end, domestic banks began to raise capital.

Domestic Cypriot banks lost significant capital after the voluntary participation in the newly-agreed haircuts of about 70% on Greek sovereign debt. The total exposure of the consolidated Cypriot banking sector to Greece amounted to about EUR 25 billion, after the 60% of the haircut on the Greek Government Bond holdings (Table 5). This represents a large share relative to the small size of the economy since it amounts to 144% of GDP. The largest exposure comes from the loan books of domestic banks, representing 89% of the full exposure. The remaining exposure is to the Greek sovereign, reaching EUR 2.8 billion (16% of GDP) at the end of 2011. This data still takes into account following haircuts on the nominal values of Greek government bond holdings: Bank of Cyprus and Marfin - 60%, and Hellenic - 70%. After these impairments on their Greek sovereign debt, domestic banks capital ratios fell substantially below the required regulatory levels with Core Tier 1 at 4.2%.

Table 5: Exposure of domestic Cypriot Banks and foreign subsidiaries to Greece

	in EUR billion				in % of total assets				in % Cypriot GDP			
	Domestic banks		Foreign subsidiaries*		Domestic banks		Foreign subsidiaries*		Domestic banks		Foreign subsidiaries*	
	Dec-11	Sep-11	Dec-11	Sep-11	Dec-11	Sep-11	Dec-11	Sep-11	Dec-11	Sep-11	Dec-11	Sep-11
Holdings of Greek Government bonds	2.2	4.7	0	2.4	1.5	4.3	0	9.4	12.6	25.7	0	13.1
Holdings of Greek bank bonds	0.3	0.4	1.0	1.0	0.2	0.4	3.9	3.9	1.7	2.2	5.5	5.5
Direct loans to borrowers in Greece	21.8	23.4	0	0	14.9	21.5	0	0	126.0	128.1	0	0
Total	24.3	28.5	1.0	3.4	16.6	26.1	3.9	13.4	140.3	156.0	5.5	18.4

Source: Central Bank of Cyprus and ECFIN calculations.

Foreign subsidiaries have transferred all Greek government bonds to their parent banks, eliminating a significant part of the risk. Following the final agreement on private sector involvement (PSI) in the impairments on Greek sovereign bonds, Greek subsidiaries in Cyprus moved all their Greek holdings, amounting to EUR 2.4 billion, to the books of the parent banks in March 2012. The capital buffers foreseen in the second Greek assistance programme to cope with the implications of PSI already included coverage for the bonds held by the subsidiaries in Cyprus. The only exposure left is EUR 1 billion in the form of Greek bank bonds, which are in principle fully covered by cash collateral from the parent bank. Hence, the risk for the Cypriot Treasury to recapitalise Greek subsidiaries disappeared.

Currently, solvency ratios of the Greek subsidiaries stand above those of domestic banks with Core Tier 1 exceeding 10%.

Bank of Cyprus and Cyprus Popular (Laiki) Bank faced significant losses due to impairments on their Greek sovereign holdings, and both require an increase in capital to bring it back up to regulatory minimum. The two banks voluntarily participated in the latest deal on impairments on Greek sovereign bond holdings, PSI, while both of them applied a haircut of over 74%. These haircuts have tightened banks' capital bases to well below the regulatory minimums.

Both banks have also issued covered bonds in order to adjust liquidity needs. On 22 July 2011, Laiki Bank completed an issuance of EUR 300 million and, on 20 July, Bank of Cyprus issued EUR 700 million in covered bonds with a maturity of two years, an extension period of one year and an annual interest rate of the three-month euribor plus 2%. The covered bonds have been rated Baa1 by Moody's. They are covered by residential loans and have been admitted for listing and trading on the Irish Stock Exchange. The issue of covered bonds was completed under a EUR 5 billion Covered Bond Programme, in accordance with the Covered Bond Law of 2010, which came into force on 23 December 2010 and the Central Bank of Cyprus directive, which was issued under the provisions of the above Law.

After the voluntary haircuts, the value of Greek bonds in the portfolio of the two largest Cypriot banks declined drastically. Following an impairment of about 76.4% on their Greek sovereign holdings, at the end of 2011, Cyprus Popular (Laiki) Bank's total exposure to Greek government bonds declined from EUR 3.5 billion in June to EUR 0.7 billion (2.1% of assets) (Table 6). Bank of Cyprus reduced its exposure from EUR 2.4 billion at the end of 2010 to the book value of EUR 0.6 billion¹³ (2.9% of assets) at the end of 2011, which also represents a discount of 74% of the total nominal value. The stock prices of the two major Cypriot banks have been falling since the outbreak of the crisis, mainly reflecting market concerns related to developments in Greece (Graph 32).

Table 6: Exposure of Bank of Cyprus and Cyprus Popular (Laiki) Bank to Greece (end 2011)

	in EUR billion		in % of total assets		in % Cypriot GDP	
	Bank of Cyprus	Cyprus Popular (Laiki) Bank	Bank of Cyprus	Cyprus Popular (Laiki) Bank	Bank of Cyprus	Cyprus Popular (Laiki) Bank
Holdings of Greek Government bonds	0.6	0.7	1.6	2.1	3.5	4
Direct loans to borrowers in Greece	10	11.8	26.4	34.7	57.6	68.1
Total	10.6	12.5	28	36.7	61.1	72.2

Source: Quarterly reports of the reporting banks and own calculations.

4.4.2. Deleveraging of banks

Cypriot banks are highly exposed to private borrowing, especially from Greek debtors. This has increased the risk of high non-performing loans, leading to decisions by the management of the banks to grant a grace period to borrowers and to reduce the applicable interest rate. Cyprus banks attach several prerequisites to the relaxation of the terms; thus, the system has not been abused by debtors not in need of such arrangements. Nevertheless, the

¹³ According to the latest available data, Bank of Cyprus further reduced its holdings of Greek government bonds to EUR 1.7 billion at the end of June 2011. However, due to comparability and availability of other data, information from end-March is used here.

relaxations, including grace periods and reduction of interest rates, will reduce the revenues of the banks, at times when they are striving to recapitalise.

Asset quality in terms of non-performing loans is rapidly deteriorating. Non-performing loans (NPLs) have been increasing since 2008 and a significant deterioration took place in the second half of 2011, with the result that NPLs reached 10.2% of total loans for Bank of Cyprus and 13.9% for Cyprus Popular (Laiki) Bank by the end of 2011. The rapid worsening of asset quality comes mainly from the Greek private sector loan portfolios. Due mainly to the adverse economic environment in Greece, the repayment capacity is likely to deteriorate further and NPLs are likely to rise, leaving the banks' capital more vulnerable to losses.

4.4.3. *Credit flow*

Profitability turned negative in 2011, and liquidity deteriorated due to deposit outflows. Since the outbreak of the financial crisis, banking profitability deteriorated due to the unfavourable domestic and foreign macroeconomic environment. The locally active banks had reached the peak of their profitability in 2007. Since then, profit has been gradually declining and turned negative at the end of December 2011. Due to a substantial increase in provisioning and non-performing loans, banks' returns on assets turned negative. The loan-to-deposit ratio for the consolidated banking sector increased somewhat to 112.7%, mainly due to deposit outflows from the Greek bank branches.

Although banks are supported by a strong deposit base, partly of foreign origin, funding and liquidity remain among the main risks for financial stability. Funding remains rather tight and the dependence on foreign deposits poses a risk as the latter represent one third of total banks' deposits. In 2011, the overall deposits of the consolidated banking system decreased by 11% year-on-year, mainly due to major deposit outflows to the Greek bank branches and foreign-owned corporate enterprises. These amounted to 10% for Bank of Cyprus and 21% for Cyprus Popular (Laiki) Bank by the end of 2011. As a risk management measure, **the deposit insurance scheme was strengthened in July 2009.** Thus, the maximum amount of compensation per depositor per bank was increased from EUR 20,000 to EUR 100,000, including all currencies. Co-insurance was abolished and claims of up to EUR 100,000 became fully reimbursed.

4.4.4. *Bank liquidity*

Weak funding and liquidity positions encouraged both major banks to rely more on ECB liquidity. While both banks are traditionally deposit-funded, they acknowledged deposit outflows in 2011. Consequently, their loan-to-deposit ratios deteriorated significantly between June and the end of 2011 from 86% to 97% for Bank of Cyprus and from 111% to 123% for Laiki. Customer deposits represent 78% of Bank of Cyprus' total assets, while this ratio stands at 59% for Cyprus Popular (Laiki) Bank. Although Cyprus Popular (Laiki) Bank substantially increased its dependence on ECB liquidity to EUR 8 billion or 20% of total assets, Bank of Cyprus' reliance on ECB funding is less at 5% of total assets.

The Government has introduced a Special Government Bond Scheme (SGBS) for banks to acquire ECB liquidity. This scheme was reviewed and approved by the European Commission¹⁴. The aim of the scheme, amounting to EUR 3 billion, was to enhance liquidity in the economy during the financial crisis. The government issued zero-coupon bonds, available to all credit institutions in Cyprus, including subsidiaries of foreign credit intuitions. Banks used these as collateral to obtain liquidity from the ECB or the interbank market. Although the size of the scheme is equivalent to almost 18% of GDP, it corresponds to only

¹⁴ The Commission found the measure to be in line with its Guidance Communication on state aid, on 22 October 2009: IP/09/1569.

2% of the assets of eligible institutions. The bonds, which carry a maximum term up to three years, were issued against high-quality collateral, comprised of domestic housing loans in combination with market loans on securities.

5. POLICY CHALLENGES

The preceding analysis has shown that Cyprus is experiencing very serious macroeconomic imbalances, which need to be urgently addressed. In particular, macroeconomic developments as reflected in the current account, public finances and the financial sector require close monitoring and urgent economic policy attention in order to avert any adverse effects on the functioning of the economy and of economic and monetary union.

Cyprus has already taken measures to address the deteriorating public finances, but more needs to be done. During the second-half of 2011, the Cypriot authorities embraced an ambitious expenditure-driven consolidation strategy reflected in the budget for 2012. However, the timely correction of the excessive deficit in 2012 requires early adoption of additional corrective measures, which the government has pledged to do. Beyond this first step, Cyprus should move towards its medium-term objective of a balanced budget in structural terms by 2014 (as reaffirmed in the Stability Programme) and thereby reverse the upward trend of the debt-to-GDP ratio by 2015. Credible implementation and adherence to this strategy will help restore financial market confidence as a precondition for a moderation of interest rates on Cyprus' sovereign securities. Confidence will further be underpinned, if the government honours its commitment to submit a law introducing a medium-term budgetary framework providing for binding fiscal rules.

Given the large exposure of the Cypriot financial sector to the Greek economy, banks' asset performance, profitability, capital, and liquidity buffers have been negatively affected by the losses on Greek government bonds under the PSI and the asset quality deterioration in both Cyprus and Greece. As a response to this challenging environment, Cyprus adopted on 14 December 2011 two bills to strengthen the system's resilience against banking crises. The first bill allows the Ministerial Council- in cooperation with the Central Bank of Cyprus- to take, in times of financial crisis, measures to address liquidity/solvency problems and/or to strengthen banks' capital base. Such government support, if given, would first require clearance against EU state aid rules. The second bill provides for the establishment of an independent financial stability fund. However, the supervision of co-operative credit societies needs to be strengthened in order to be in line with the standards applied for the commercial banks.

In order to meet the new requirements for a temporary increase of banks' capital to a 9% core Tier 1 capital ratio by mid-2012, the banks concerned are currently implementing their capital strengthening plans. These include new equity issuance, conversion of existing hybrid capital to eligible convertible capital, restrictions on profit distributions and bonuses, and the sale of assets such as foreign subsidiaries. The smooth recapitalisation of the Cypriot banks needs to be secured, as it is so far proving challenging. Successful implementation of the announced capital strengthening plans is crucial to avert further need for government support on top of the recent 1.8 billion rights issuance to recapitalise Cyprus Popular Bank.

First steps in the right direction have been taken to restore and sustain competitiveness, but their relevance and credibility depends crucially on the degree of ambition and enforcement. Wage growth is expected to moderate given unfavourable labour market conditions. Besides, with the public sector's de-facto role as wage leader, government wage restraint in the course of fiscal consolidation is expected to spill over to the private sector. The government introduced a two-year pay freeze in the broader public sector including the automatic cost-of-living –adjustment (COLA) as well as the seniority-based rises. In parallel, the government

and social partners agreed to embark on a dialogue with the aim of reviewing the COLA system by the end of June 2012.

In an effort to enhance the country's growth potential, employment, productivity and competitiveness, the government prepared a wide-ranging package of measures, adopted by the Council of Ministers, consisting of measures to support employment, institutional arrangements for attracting public and private investment, and measures to enhance the role of Cyprus as an international business and financial centre providing high-value-added services. The measures are intended to form an immediate response to the economy's contraction at a time when fiscal consolidation measures would be taking full effect.

Cyprus has also adopted some structural reforms aimed at boosting productivity and growth. As highlighted in the assessment of the 2012 National Reform Programme, the government has taken steps to adapt the education and training system to labour market needs, with the gradual introduction of new curricula from primary up to the first year of upper secondary education, focusing on the development of key skills, while a new apprenticeship scheme is being developed. It has also continued to implement measures to improve the employability of jobseekers and inactive persons, as well as of secondary and tertiary graduates. Yet, in addition to these efforts to improve the supply of skilled labour, it will be necessary to stimulate demand for the highly-qualified through new business initiatives and innovation. Cyprus took steps to boost growth in the services market by transposing the Services Directive. However, in sectors such as retailing, tourism, and construction, sector-specific legislation is still pending. To enhance the business environment, the Point of Single Contact (PSC) was set up through the upgrading and expansion of the One-Stop Shop. Cyprus has so far taken significant steps to better serve citizens and to enhance the productivity and effectiveness of public services. Citizens' Service Centres (CSC) are now operating, while the Companies Registration System (e-filing), allowing for complete online registration of companies, is expected to partly address the cost of setting up a business in Cyprus, which is higher than the EU average.

Measures to reduce private indebtedness have not been introduced yet. Although the property bubble was not as detrimental for the economy as in some other countries, measures are needed to prevent such a bubble in the future. The government should target its government housing policy, to avoid increasing housing loan demand. Also, procedures and regulation for building approvals and deeds should be made more efficient, to address the significant delays in issuing title deeds. Currently the long average time of obtaining a title deed is an impediment to concluding transactions in the housing market, thereby affecting the risk of the collaterals. Moreover, although credit conditions in Cyprus are already tight, a more conservative stance could be adopted, with the maximum loan amount to total amount of collateral be augmented. In regards to the corporate sector indebtedness, regulation should make companies' owners or stakeholders more liable to their companies' loans. Also, the supervision of the banking sector should be more significant, requiring high capital buffers, as better risk management. Last, price wars between financial institution that drive deposits and loans interest rates up should be closely monitored by the supervisory authorities.

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