PLANNING AND RESEARCH DIVISION

THE ECONOMY OF CYPRUS

April 2010

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Economy

Background

Cyprus is a small island of a total area of 9.251 sq. kilometers, and hence a small economy. Since 1974, following the Turkish invasion, Cyprus has been divided de facto into the Greek-Cypriot government-controlled two-thirds of the island and the remaining one-third of the island, which is administered by the Turkish Cypriots. All subsequent references to the Cypriot economy refer to the Greek-Cypriot government controlled area.

The Cypriot economy's breakdown by sector is as follows:

- **Agriculture and natural resources** (2009 est.): 2,1% of GDP. The main agricultural products that Cyprus produces are potatoes and other vegetables, citrus fruits, olives, grapes, wheat and carob seeds. Main natural resources include pyrites, copper, asbestos, gypsum, lumber, salt, marble, clay, earth pigment.
- **Industry and construction (2009 est.):** 19% of GDP. Main industries are those related to mining, cement, construction, utilities, manufacturing, chemicals, non-electric machinery, textiles, footwear, food and beverages.
- **Services and tourism (2009 est.):** 78,9% of GDP.

Cyprus has long been referred to as the bridge between three continents, linking the East and West. The island has an open, free market, services-based economy with some light manufacturing. Cyprus' accession to the European Union, which took place on 1st May 2004, is considered an important milestone in its recent economic development and has certainly shielded its small economy to some extent during the recent financial crisis. On the same date, a number of other countries also joined the EU (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia).

In the past 20 years the Cyprus economy has gradually shifted from agriculture and light manufacturing to services. In recent years, the services sector and financial services in particular, have provided the main impetus for growth, while tourism has been declining in importance. The island has few proven natural resources. Trade is vital to the Cypriot economy and most goods are imported. The trade deficit increased in 2008, reaching 32,2% of

GDP, while in 2009 the trade deficit was contained at 25,1% of GDP. Cyprus must import fuels, most raw materials, heavy machinery, and transportation equipment. Approximately 70% of its imports come from the European Union, particularly Greece, Italy and the United Kingdom, while less than 2% come from the United States.

GDP growth has been fairly strong in the period 2007-2008, registering 5,1% and 3,6%, respectively. However, the global financial turmoil has taken its toll on the island's economy (see section 'Economic Developments 2009', below).

Cyprus has been a successful member of the Euro area since January 1, 2008, when it replaced the Cyprus Pound with the Euro. Joining the Euro area, was a major accomplishment for the Cypriot economy, resulting in such benefits as, higher degree of price stability, lower interest rates, reduction of currency conversion costs and exchange rate risk, and increased competition through greater price transparency. The final conversion exchange rate between the Cypriot pound and the Euro was one Euro per 0,585274 Cyprus pounds.

Cyprus offers high quality business and financial services, modern telecommunications, an educated labor force, good airline connections, and a sound legal system. Cyprus' geographic location, tax incentives and modern infrastructure also make it a natural hub for companies looking to do business with the Middle East, Eastern Europe, the former Soviet Union, the European Union and North Africa. As a result, Cyprus has developed into an important regional and international business center. Cyprus ranks among the world's leading countries per capita in terms of attracting FDI. Non-EU investors (both natural and legal persons) may now invest freely in Cyprus in most sectors, either directly or indirectly (including all types of portfolio investment in the Cyprus Stock Exchange). The only exceptions concern primarily the acquisition of property and, to a lesser extent, restrictions on investment in the sectors of tertiary education, banking and mass media.

Economic Developments 2009

The Cyprus economy decelerated sharply throughout 2009. The economic slowdown was evident since the last quarter of 2008, even though for the whole of 2008 GDP growth was a satisfactory 3,8%. However, in 2009 growth was severely affected by the internationally adverse economic environment, the tightening lending conditions, the restructuring of corporate balance sheets and high household indebtedness.

Cyprus recorded a negative growth rate overall for 2009 of –1,7%, for the first time in 30 years. The downturn took a negative toll on public finances since for the period January – December 2009 the fiscal balance exhibited a severe deterioration compared to the corresponding period of the previous year. More specifically, for the said period, the **fiscal balance ended in a deficit of –6,1% of GDP**, compared to a surplus of 0,9% of GDP over the corresponding period of 2008. Over the 12-month period public revenues exhibited a profound decrease by 8,9%. This was mainly the result of a substantial slowdown in the real estate and construction sectors and hence the fading out of public revenues related to the real estate boom of the recent years. At the same time, public expenditure for the whole year increased by 7,0%, as a result of payroll increases and increases in capital expenditure.

The Ministry of Economics and Finance has included a target for the fiscal deficit remaining at –6,0% of GDP for 2010 (and –4,5% of GDP for 2011) in the Stability Programme 2009-2013. For years 2012 and 2013 the targets are set at –3,4% of GDP and –2,5% of GDP, respectively. The government has set a goal for fiscal policy to focus on growth and social cohesion, through the redirection of resources to growth-enhancing activities and prioritization of expenditure programmes. Structural reforms must be implemented in various areas including healthcare, labour markets, fiscal policy and to boost the 'green economy'. Particular emphasis is to be placed on the need to curtail expenditure and restructure public spending, in favour of capital expenditure and education, which can boost the economy's growth potential. Redirecting resources towards infrastructure is particularly important since the construction sector is expected to exhibit negative growth. Emphasis is also to be placed to targeted social spending.

Public debt levels had been on the decline up to year end 2008 when it contracted to 48,4% of GDP, down from 58,3% of GDP in 2007 and 64,6% of GDP in 2006. However, **in 2009** the public debt rose anew to **56,2% of GDP** by year-end and it is projected (as per the targets set in the Stability Programme 2009-2013) to rise further to 61% of GDP in 2010. The targets for years 2011 – 2013 are at 63,2%, 63,1% and 62,3% of GDP, respectively.

Inflation (based on the Harmonized Index of Consumer Prices) retreated considerably and for the 12-month period from January to December **2009 was at 0,2%**, compared to 4,4% during the corresponding period of 2008. Significantly lower inflationary pressures were the result of lower oil, natural gas and electricity prices, the global recession and the slowing of economic activity domestically.

On the other hand, **unemployment** was on a rising path during **2009 and rose to 5,3%** (compared to 3,7% the corresponding period of 2008). Following many years of tight labour market conditions and relatively low unemployment (even after taking into consideration the significant inflow of foreign workers), the slowdown of economic activity, has visibly affected employment growth, which in 2009 is estimated to have contracted for the first time in many years by some 0,75%, compared to the previous year (after growing by an average 2,5% annually since 2000). The subdued economic outlook should continue to weigh particularly on labour-intensive sectors in 2010, especially construction and tourism.

In constant prices, **total exports** are estimated to have **declined by 11,8% in 2009**; both exports of goods and services registered large drops compared to the previous year. Export of services were significantly affected by a 11% fall in tourist arrivals and 17% fall in revenue income from the sector, as well as, by a large decline in income form shipping services. Other services, such as financial services and other business services (legal, consultancy, accountancy etc), registered, in some cases, positive growth, offsetting to some extent the poor export performance elsewhere.

Imports fell overall by nearly 20% in constant prices, owing to declines in most categories of goods, as well as, services. This implies that low consumption and investment demand were reflected mainly in lower imports. As a result, the **current account deficit**, which soared to 17,7% of GDP in 2008, has **narrowed markedly in 2009, to an estimated 8,5% of GDP**.

Gross Fixed Capital Formation, is estimated to have declined by 12% in real terms, owing to significant falls in construction investment (8,5%), investment in transport equipment (55,2%), and investment in machinery and equipment (12,6%). The fall in investment in construction was partly the result of the economic slowdown in the UK and Russia, having been the main source countries for investment in the secondary residences in coastal areas in recent years.

Table 1: ***Cyprus Main Economic Indicators 2006 – 2010***

	2006	**2007**	**2008**	**2009**1	**2010**1
GDP/capita (€ current prices)	*18.538*	*20.118*	*21.644*	*20.993*	*21.180*
G.D.P. (real growth rate - %)	*4.1*	*5.1*	*3.6*	*-1.7*	*0.5*
Private Consumption (Δ%)	*4.7*	*9.4*	*8.4*	*-3.0*	*0.5*
Investments (Δ%)	*7.6*	*14.6*	*10.3*	*-28.5*	*10.7*
Investments/GDP (%)	*20.6*	*22.4*	*23.9*	*17.4*	*19.1*
Unemployment rate (%)	*4.5*	*3.9*	*3.7*	*5.3*	*6.5*
Inflation rate (%)	*2.5*	*2.4*	*4.7*	*0.3*	*3.0*
Harmonized rate of Inflation (%)	*2.2*	*2.2*	*4.4*	*0.2*	*2.7*
Fiscal deficit/surplus (%GDP)	*-1,2*	*+3,4*	*+0,9*	*-6,1*	*-6,0*
Public debt (%GDP)	*64,6*	*58,3*	*48,4*	*56,2*	*61,0*
Trade Balance (%GDP)	*-27.2*	*-29.7*	*-32.2*	*-25.1*	*n.a*
Current Account Balance (%GDP)	*-7,0*	*-11,7*	*-17,7*	*-8,5*	*-11,5*
Tourist Arrivals (Δ%)	*-2,8*	*0,6*	*-0,5*	*-10,9*	*0.3*
Tourist Receipts (Δ%)	*2,2*	*5,9*	*-3,5*	*-16,7*	*-1.6*
*ECB marginal lending facility (31 Dec.-%)**	*4,25*	*4,00*	*3,00*	*1,75*	*-*
Exchange rates (annual average)					
€/US$	*1,2556*	*1,3705*	*1,4708*	*1,3896*	*-*
€/GBP£	*0,6817*	*0,6843*	*0,7963*	*0,8865*	*-*

Sources: Ministry of Finance, Cyprus Statistical Service, Stability Programme of the Republic of Cyprus 2009-2013 (March, 2010).

1: projection n.a.: not available

Note: As of 1st September 2006, the main refinancing operations rate (repo) replaced the marginal lending facility rate (Lombard) for the purpose of pricing local currency bank loans. It is also noted that as of 1st January 2008, Cyprus joined the eurozone and therefore, interest rates are set by the European Central Bank.

Outlook 2010-2013

Year 2010 is most likely to prove another **difficult year for tourism and construction** in Cyprus, the two sectors being the key drivers of Cypriot economic growth in recent years. According to the Stability Programme of the Republic of Cyprus 2009-2013, even though the economy is expected to return to modest growth in 2010, structural problems in domestic markets will weigh on the recovery of the abovementioned two sectors in the near term. Additionally, **overall uncertainty remains quite elevated worldwide, and economic growth in the EU is expected to be anemic in 2010**, with continued **negative developments in labour markets**.

Domestically, in the **tourism sector**, the crisis has exposed key weaknesses in the industry, with high prices and an overdependence on British arrivals being the main problems. UK tour operators have started 2010 by offering huge discounts for early bookers, a fact which will result in a disappointing revenue growth again in 2010. However, higher occupancy rates are expected to boost seasonal employment in the sector during the summer months.

In the **construction industry**, there is still a great deal of uncertainty. According to BMI's view a stabilization and modest recovery is to be expected in the short term, not excluding the possibility of a stronger rebound. The number of dwelling units that received building permits over January to December 2009 fell 16,9% y-o-y, indicating that investment in the sector has dried up. Additionally, oversupply of properties in the market will exert further downward pressure on house prices in the short-term, with heavily indebted developers seeking to first clear a backlog before moving on to build new projects.

Similarly, according to the Cyprus Ministry of Economics and Finance and the Stability Programme 2009-2013 it submitted late in March 2010, the continuing international economic crisis and the dramatic deterioration of economic environment in key countries for the secondary-residence market (United Kingdom and Russia), will most probably continue to limit the construction of new residences over the next years in Cyprus. As also pointed out above, the construction sector is to undergo an adjustment in the medium term, due to the fall in demand and the existence of a considerable backlog of residences available for sale. This adjustment is further complicated by the significant depreciation of the sterling over the past few years.

In general, the Stability Program, notwithstanding the high degree of uncertainty for the short-to-medium-term prospects of the economy of Cyprus, envisages a gradual recovery towards a **lower potential GDP growth**. Indeed, the recent financial crisis has affected not only economic activity, but possibly also the potential output (the output level consistent with full utilization of all the available production factors, labour, capital and technology), with implications for the long-term economic outlook. This is in line with a European Commission's analysis, which also reports that unless policies address new challenges, potential GDP in the EU could fall to a permanently lower level. This is explained by firstly, the high unemployment levels, tending to over time lead to a permanent loss of skills. Secondly, the stock of equipment and infrastructure which will decline and become obsolete due to lower investment, and thirdly, innovation which may be hampered, as spending on research and development is one of the first outlays that businesses cut back on during recessions (European Commission, DGECFIN, 7/2009).

GDP growth is projected for the whole of 2010 to turn positive at +0,5%, as per the Stability Programme. A gradual recovery is foreseen, in line with the envisaged rebound in foreign demand. Private consumption is expected to grow in line with disposable income, or by some 3,3% over the period 2010-2013, compared to 4,7% in the period 2005-2009. The key drivers supporting private consumption are employment growth (projected to average by 0,9% over 2010-2013) and real wage growth of some 2%. However, it should be noted that the **International Monetary Fu**nd, in its World Economic Outlook report, released in April 2010, projects a **contraction of GDP in 2010 of -0,7%**.

Public consumption growth is expected to moderate somewhat in the medium term, as a result of **fiscal consolidation** assumed in the Stability Programme. Compared to an average growth of 4,6% over the period 2005-2009, public consumption is set to moderate to 1,1% per annum over 2010-2013. Investment is to continue to contract over the medium term, mainly due to the projected correction of the construction sector. Based on the Stability Programme, **overall, gross fixed capital formation is expected to contract by 1,2% per annum over the period 2010-2013**, compared to 4,9% increase during 2005-2009.

Ratings

Fitch Ratings (17-Jun-09)

	Ratings
Foreign Currency	
Long-term IDR	AA-
Short-term IDR	F1+
Local Currency	
Long-term IDR	AA-
Country Ceiling	AAA

Moody's Ratings (28-Aug-09)

Country Ceiling: Bond rating foreign currency	Aaa
Country Ceiling: Bond rating local currency	Aaa
Government of Cyprus	
Government Bonds – Foreign Currency	Aa3
Government Bonds – Domestic Currency	Aa3
Outlook	Stable

It is noted that Fitch Ratings affirmed the above ratings on 12 February 2010. In their report published in June 2009, Fitch stress that Cyprus is now in its second year of membership of the euro area and is gaining the long anticipated benefits from this fact. According to Fitch, Cyprus' GDP has grown rapidly, averaging almost 4% per annum over the past decade, approximately double the EU average. This has brought its GDP per head up to 93% of the EU27 average. However, Fitch remain concerned by the large and persistent Cypriot current account deficit, partly reflecting continuous loss of international competitiveness, both within the euro area and outside it.

The global financial crisis inevitably affected Cyprus' economy, which has a significant dependence on tourism, while residential construction was also affected (much of which was linked with tourism and has been in decline since mid-2008). Cyprus successfully pursued a policy of fiscal consolidation over the past four years – necessary to qualify for EMU membership – and has achieved overall surpluses on its general government accounts in the past two years, as well as reducing its debt from 70% of GDP in 2004 to 49% at end-2008. However, as projected by Fitch, the balance did sink back into deficit in 2009 and expected to remain so for 2010.

The domestic banking industry has had negligible involvement with toxic products. Most of its lending has been in Cyprus or Greece. Foreign currency deposits, a high proportion of which come from Russia, are subject to a minimum liquid asset requirement of 70%. Bank regulation is conservative. Nonetheless, the individual banks are relatively weak by western European standards and it is not known how far non-performing loans will increase.

In conclusion, Fitch believe that the performance of the Cypriot economy in 2010 will depend on the success of the major European countries, including Russia, which plays an increasing part in Cypriot tourism and banking, to get their own economies moving and, therefore, stimulate demand in Cyprus. The success of official fiscal consolidation in the years preceding euro area entry has also left the government with some room to manoeuvre during the recession: the small surplus in 2008 has become a deficit in 2009 and public debt will commence rising again albeit at a slow pace. Inflation has already tumbled, while unemployment has begun to rise. Externally, Fitch expects no improvement in the current account for some years as both exports and imports are likely to be equally affected by the recession. Falling oil prices will clearly be of benefit to Cyprus (but they have already begun to recover). The big uncertainty lies in the number of tourist arrivals, which were down by more than 10% in 2009 as a whole.

Moody's Investors Service in their report on 28 August 2009, point out that economic growth in Cyprus has been remarkably resilient in the current global crisis, reporting positive growth in the first quarter of 2009. The country has benefited from its domestic demand-based growth and its relatively low dependence on manufacturing exports. However, both financial services and real-estate sectors that propelled the economy in recent years – are struggling. Furthermore, the double-digit current account deficit reflects a lack of competitiveness. This is partly due to the backward looking automatic indexation mechanism (COLA) that has induced wage increases that are hardly compatible with productivity gains.

Although the financial sector has not required public capital injections, Cyprus' fiscal position has deteriorated as weakening economic activity has been accompanied by considerable fiscal loosening. The government increased social spending and raised the threshold for the personal income tax. Moreover, at the beginning of this year, the government decreased the corporate tax rate of semi-government agencies from 25% to the common flat rate of 10%. Without additional consolidation measures (including a reduction in the public payroll which accounts for a third of total expenditures), the government's budget targets for 2009-2010 – as projected by Moody's – have been missed.

Moody's move further on in their report to comment upon the Cyprus long standing political issue. They report that The Republic of Cyprus and the Turkish Cypriots have been negotiating under UN auspices on reunifying the island's Greek and Turkish territories since September 2008. The aim is a loose bi-zonal federal state with a small central administration to handle predominantly international relations. Although some progress has been announced on the governance issue, EU matters and the economy chapter, a comprehensive solution to the Cyprus issue remains hard to achieve. The positions differ particularly regarding the issues of territory, security and guarantees. The talks have turned more difficult with the victory of the traditionally hardline National Unity Party (UBP) in the Turkish Cypriot zone's April elections.

It should be noted that Moody's affirmed the abovementioned ratings in a more recent report on 15 February 2010. In their report, Moody's outline their expectations of a modest recovery in overall economic activity for Cyprus in 2010 and 2011, with GDP growth rising to 0,3% and 1,8%, respectively. Preserving international competitiveness remains a challenge for Cyprus, however. Cost adjustments are complicated by COLA which tends to induce wage increases irrespective of matching productivity gains. Cyprus' fiscal position has deteriorated in 2009, due to a combination of large increases in government expenditures and a reduction in government revenues. The latter suffered particularly from a decline in capital gains tax due to the slowdown in the construction and property market.

Summary and conclusions

- **The Cyprus economy decelerated sharply throughout 2009**. Within the said year, growth was severely affected by the internationally adverse economic environment, the tightening lending conditions, the restructuring of corporate balance sheets and high household indebtedness.

- **Cyprus recorded a negative growth rate overall for 2009 of –1,7%**, for the first time in 30 years. The downturn took a negative toll on public finances since the **fiscal balance ended in a deficit of –6,1% of GDP**, compared to a surplus of 0,9% of GDP over the corresponding period of 2008.

- **Public debt** levels had been on the decline up to year end 2008 when it contracted to 48,4% of GDP, down from 58,3% of GDP in 2007 and 64,6% of GDP in 2006. However, **in 2009** the public debt rose anew to **56,2% of GDP** by year-end and it is projected (as per the targets set in the Stability Programme 2009-2013) to rise further to 61% of GDP in 2010.

- **Inflation (based on the Harmonized Index of Consumer Prices**) retreated considerably and for the 12-month period from January to December **2009 was at 0,2%**, compared to 4,4% during the corresponding period of 2008. On the other hand, **unemployment** was on a rising path during **2009 and rose to 5,3%** (compared to 3,7% the corresponding period of 2008).

- Year 2010 is most likely to prove another **difficult year for tourism and construction** in Cyprus, the two sectors being the key drivers of Cypriot economic growth in recent years. Therefore, **GDP growth is projected for the whole of 2010 to turn positive at +0,5%**, as per the Stability Programme. A gradual recovery is foreseen, in line with the envisaged rebound in foreign demand. Private consumption is expected to grow in line with disposable income, or by some 3,3% over the period 2010-2013, compared to 4,7% in the period 2005-2009. The key drivers supporting private consumption are employment growth (projected to average by 0,9% over 2010-2013) and real wage growth of some 2%. However, it should be noted that the **International Monetary**

Fund, in its World Economic Outlook report, released in April 2010, projects a **contraction of GDP in 2010 of -0,7%**.

- **Fitch Ratings** affirmed on 12 February 2010 their AA- ratings on the short-term and long-term IDR's for Cyprus. In their report published in 2009, Fitch stress that Cyprus is now in its second year of membership of the euro area and is gaining the long anticipated benefits from this fact. According to Fitch, Cyprus' GDP has grown rapidly, averaging almost 4% per annum over the past decade, approximately double the EU average. This has brought its GDP per head up to 93% of the EU27 average.

- **Fitch** believe that the performance of the Cypriot economy in 2010 will depend on the success of the major European countries, including Russia, which plays an increasing part in Cypriot tourism and banking, to get their own economies moving and, therefore, stimulate demand in Cyprus. The success of official fiscal consolidation in the years preceding euro area entry has also left the government with some room to manoeuvre during the recession: the small surplus in 2008 has become a deficit in 2009 and public debt will commence rising again albeit at a slow pace. The big uncertainty lies in the number of tourist arrivals, which were down by more than 10% in 2009 as a whole.

- **Moody's Investor's Service** also affirmed on 15 February 2010 their Aaa ratings on both short-term and long-term country ceiling bond ratings, with a stable outlook. In their report, Moody's outline their expectations of a modest recovery in overall economic activity for Cyprus in 2010 and 2011, with GDP growth rising to 0,3% and 1,8%, respectively. Preserving international competitiveness remains a challenge for Cyprus, however. Cost adjustments are complicated by COLA, which tends to induce wage increases irrespective of matching productivity gains.

Sources: Cyprus Ministry of Economics and Finance The Stability Programme of the Republic of Cyprus 2009-2013 (March 2010), Cyprus Statistical Service, Business Monitor International, Fitch Ratings, Moody's Investor's Service, Εφημερίδα 'Ο Φιλελεύθερος'.

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