

Cyprus: Macroeconomic Outlook

May 2013

Presentation

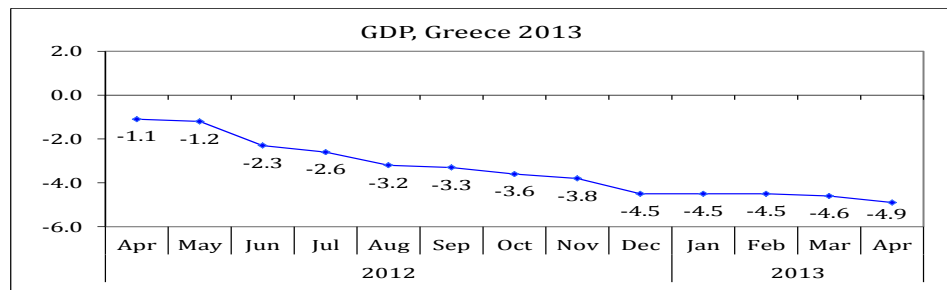
- Main messages
- Current Situation
- Memorandum of Understanding
- Medium term macroeconomic framework
- Growth measures
- Conclusions

Main Messages

- Agreement of the Eurogroup on the MOU for Cyprus, supported by IMF
- ... led to aversion of bankruptcy, and aversion of exit from the Eurozone
- ... however challenges looking forward, in particular due to weak growth outlook – achievement of the MOU targets challenging
- ... commitment to implement fiscal, structural and banking sector reforms, included in the MOU
- ... restoration of confidence to the banking sector key for gradual recovery over the medium term horizon
- Structural reforms as provided for in the MOU in conjunction with prospects in the energy sector are expected to contribute to growth over the medium term

Current Situation

External Environment

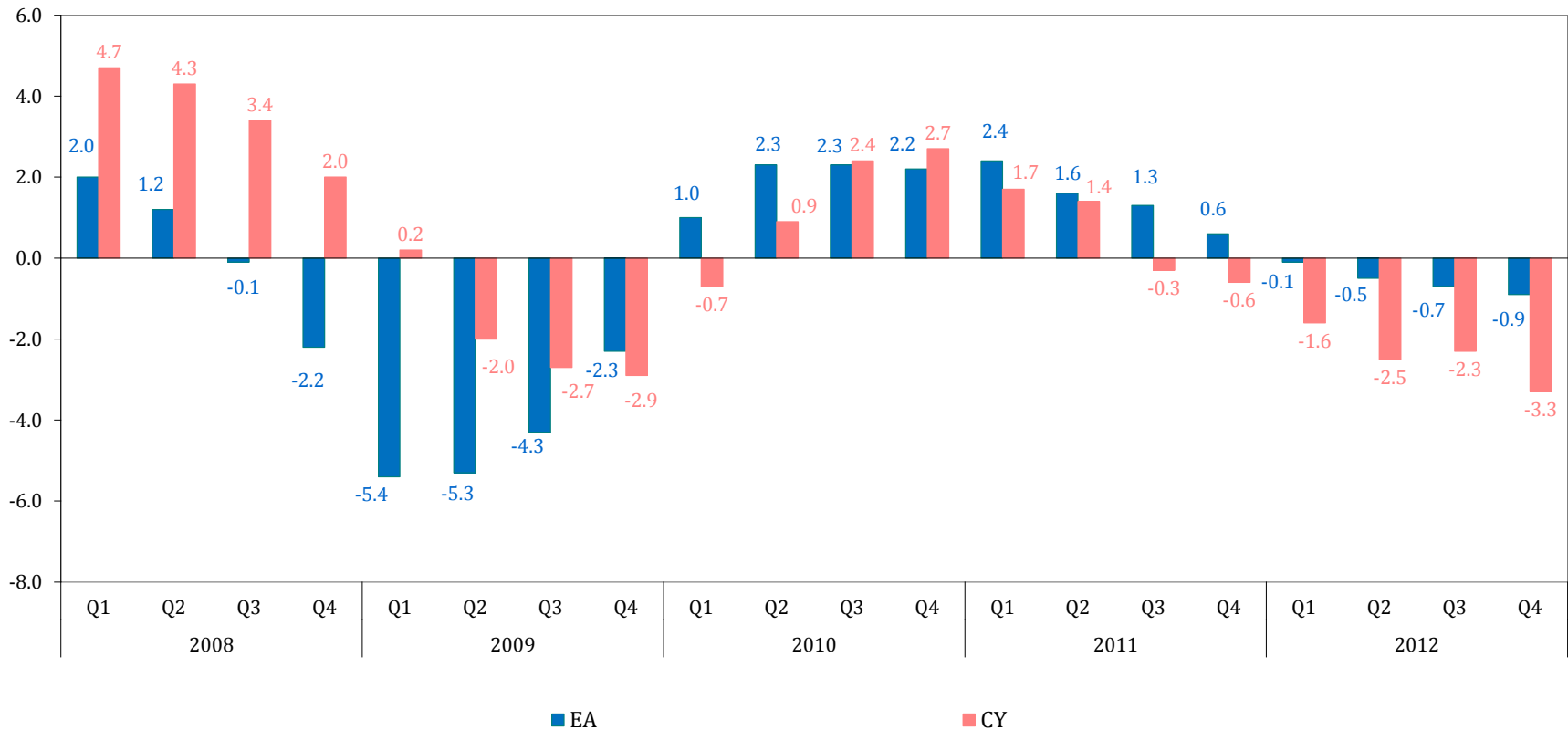


- Challenging external environment, critical for small open economies
 - weak prospects in the Eurozone, including Greece, UK
 - positive growth in Russia, however signs of slow down
 - opportunities for export of services in Middle East, India, China

Economy: Selected indicators

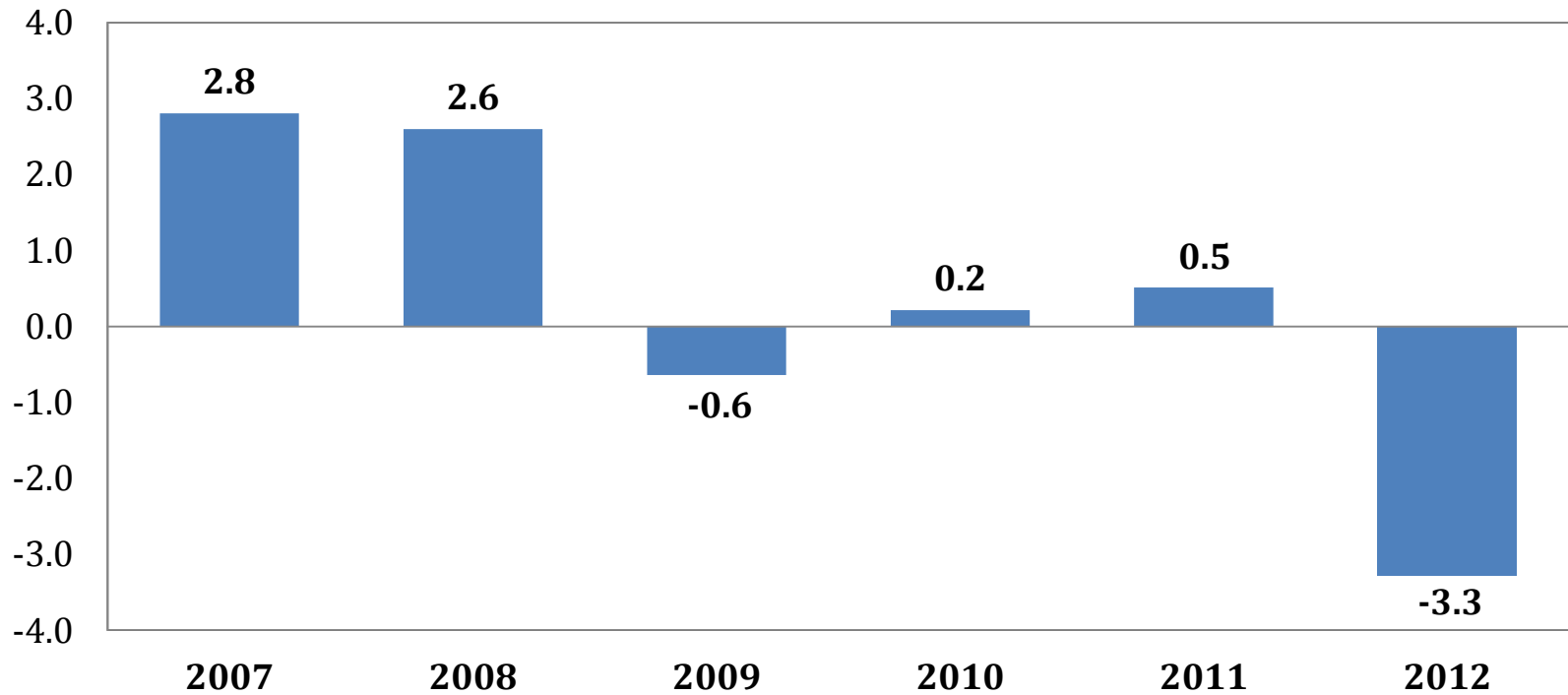
<i>annual % change</i>	2008	2009	2010	2011	2012	2013Q1
GDP growth (constant prices)	3.6	-1.9	1.3	0.5	-2.4	...
<i>Private consumption</i>	7.8	-7.5	1.5	0.5	-3.0	...
<i>Gross Fixed Capital Formation</i>	6.0	-9.7	-4.9	-13.1	-23.0	...
<i>Exports</i>	-0.5	-10.7	3.8	4.4	2.3	...
<i>Imports</i>	8.5	-18.6	4.8	-0.7	-7.2	...
<i>GDP deflator</i>	4.6	0.1	1.9	2.7	2.0	...
Tourist arrivals (000's)	2.403,8	2.141,2	2.173,0	2.392,2	2.464,9	177,2
Tourist arrivals (%)	-0.5	-10.9	1.5	10.1	3.0	-10.2
HICP (%)	4.4	0.2	2.6	3.5	3.1	1.7
Productivity growth	1.0	-1.2	1.1	0.0	0.9	...
Employment growth	2.6	-0.6	0.2	0.5	-3.3	...
Nominal Earnings (%)	5.9	4.0	2.3	2.8	1.1	...
Nominal Unit Labour Cost (%)	4.9	5.2	1.2	2.7	0.3	...
Unemployment rate (Labour Force Survey)	3.7	5.4	6.3	7.9	11.8	...
Trade balance of goods (% of GDP)	-32.4	-25.5	-26.8	-24.2	-21.5	...
Trade balance of services (% of GDP)	21.0	20.0	20.6	19.9	19.0	...
Resource Balance (% of GDP)	-11.4	-5.5	-6.2	-4.2	-2.5	...
Current account balance (% of GDP)	-15.6	-10.7	-9.8	-4.7	-11.7	...
Fiscal Deficit (% of GDP)	0.9	-6.1	-5.3	-6.3	-6.3	...
Public Debt (% of GDP)	48.9	58.5	61.3	71.1	85.8	...

GDP Growth Rate (SA data)



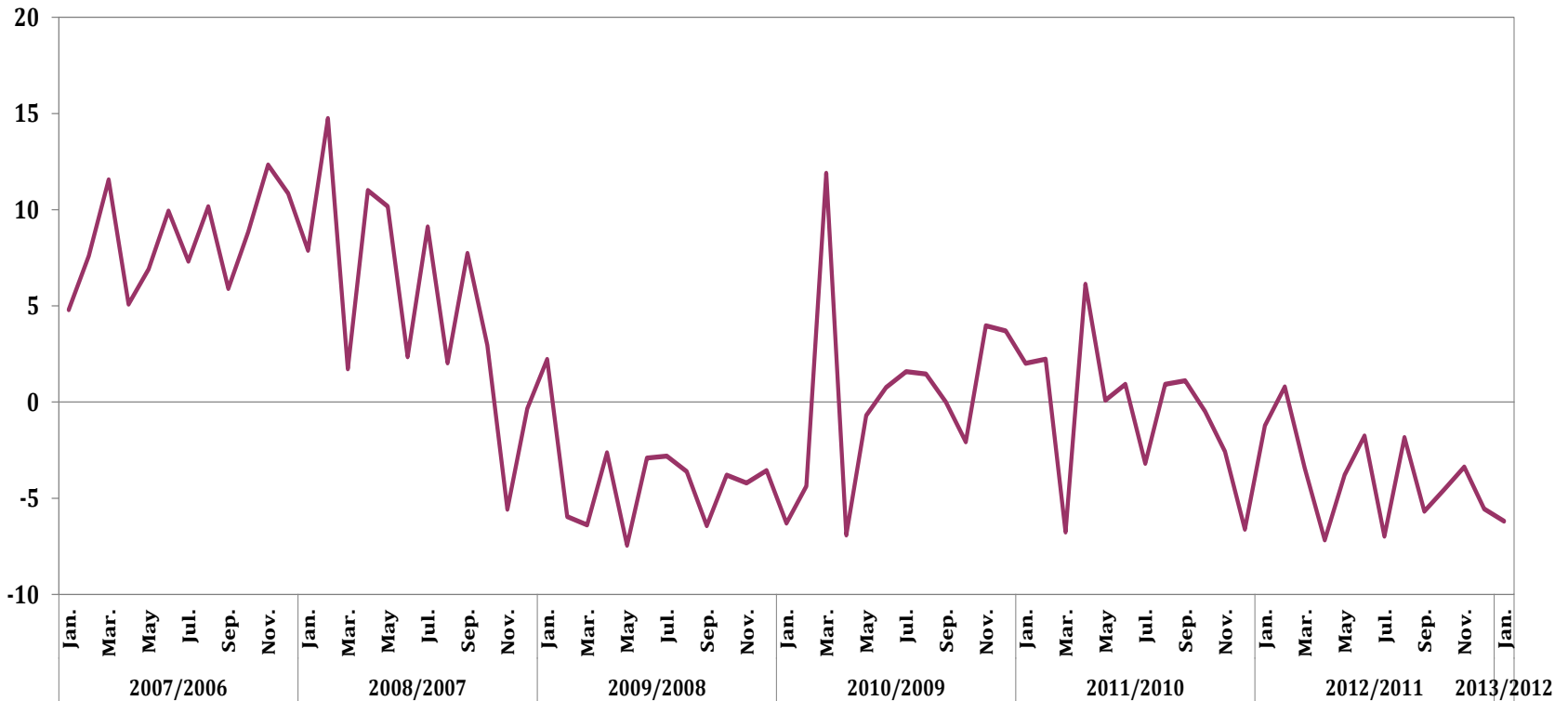
Negative factors: Challenging external environment, fiscal adjustment, bank deleveraging, reductions in disposable income, wealth and confidence effects.
 Net exports positive contribution to growth.

Employment (% change)



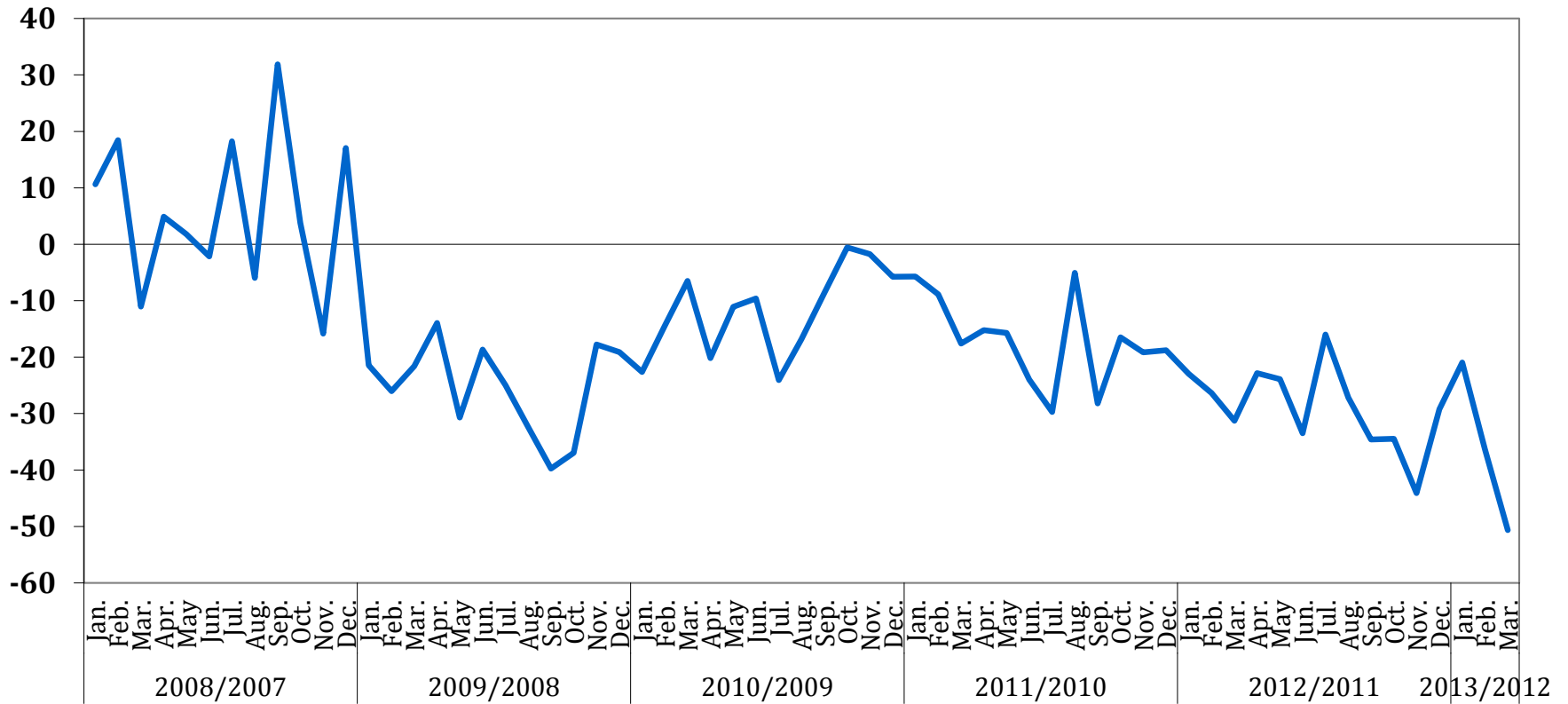
Weak growth outlook – effects on employment, including employment of foreign labour

Retail Sales (Volume) (annual change %)

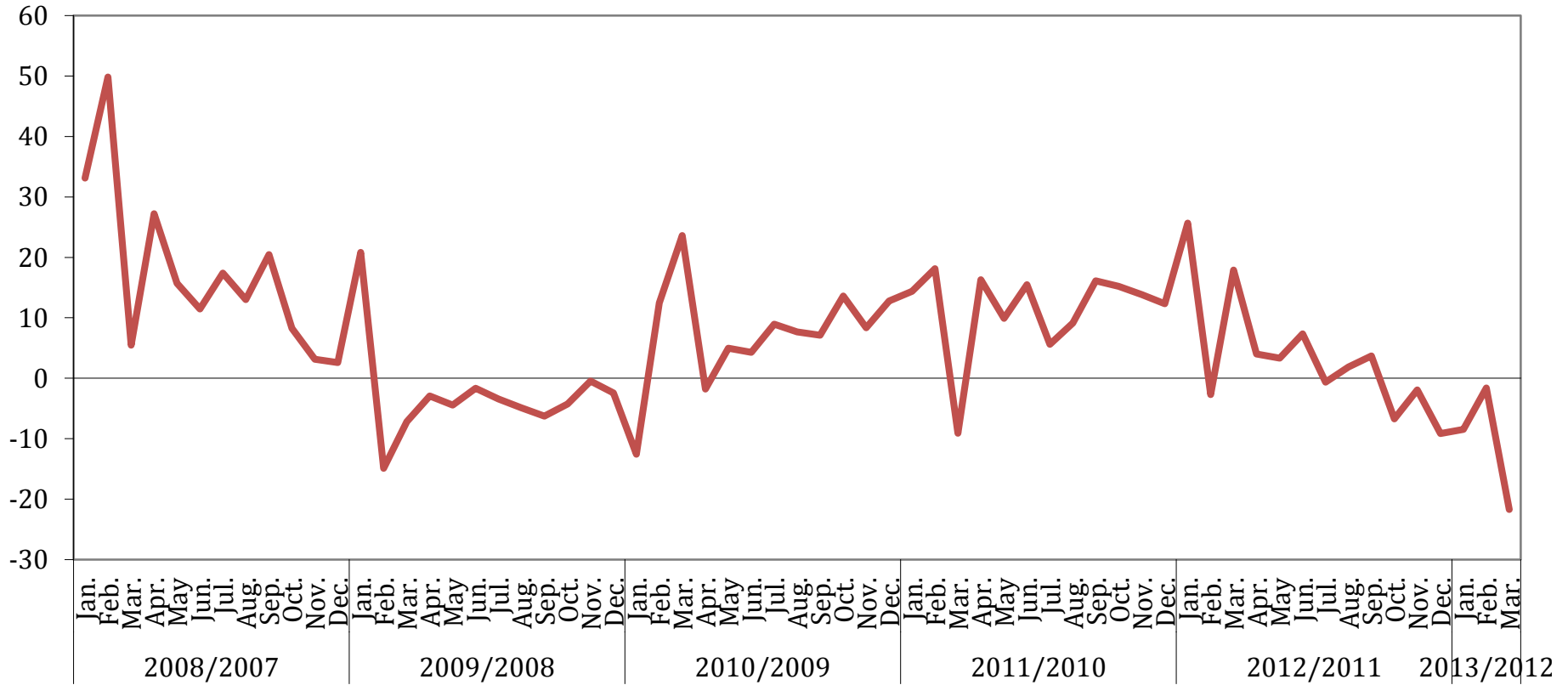


Further weakening of private consumption, in particular for durables and imported goods

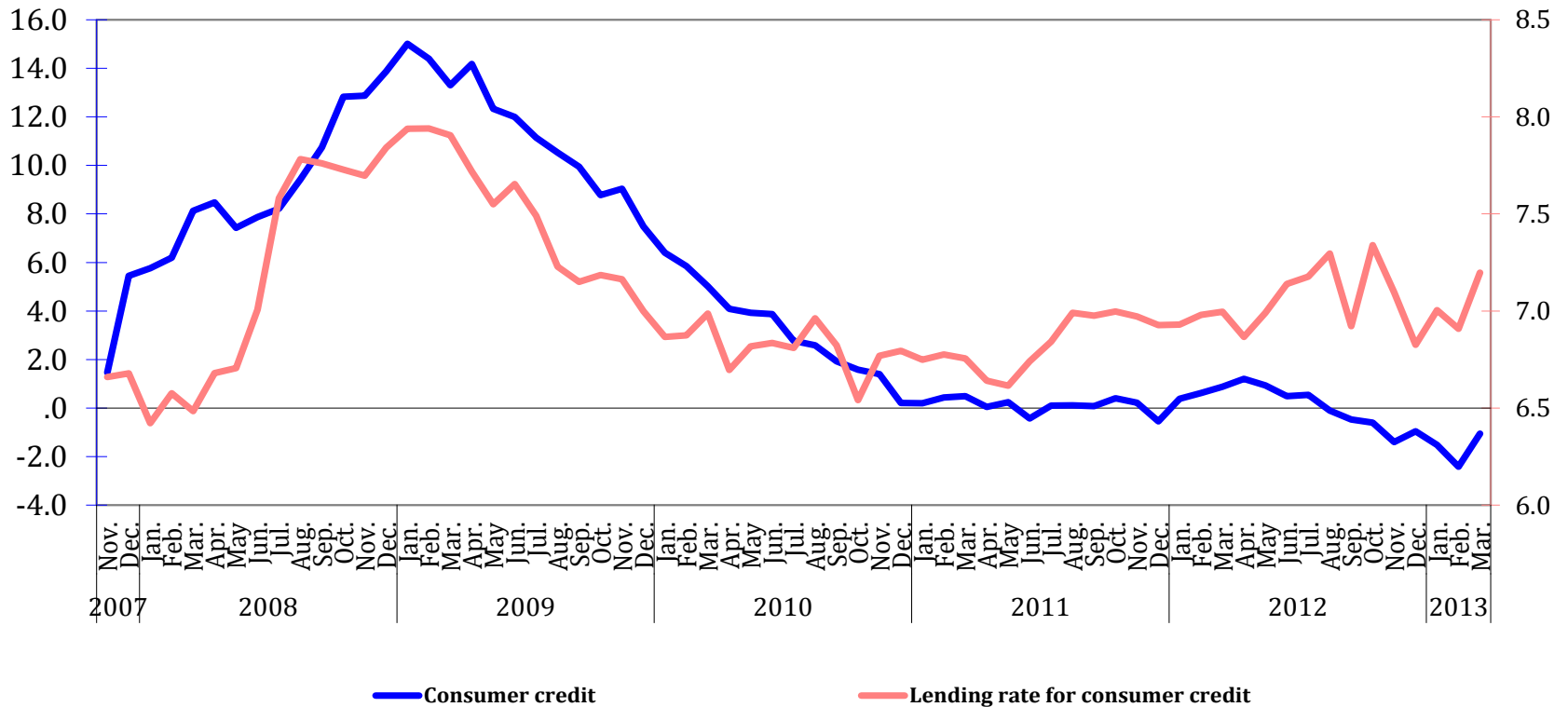
Car Registrations (annual change %)



Resident credit card transactions (annual change %)



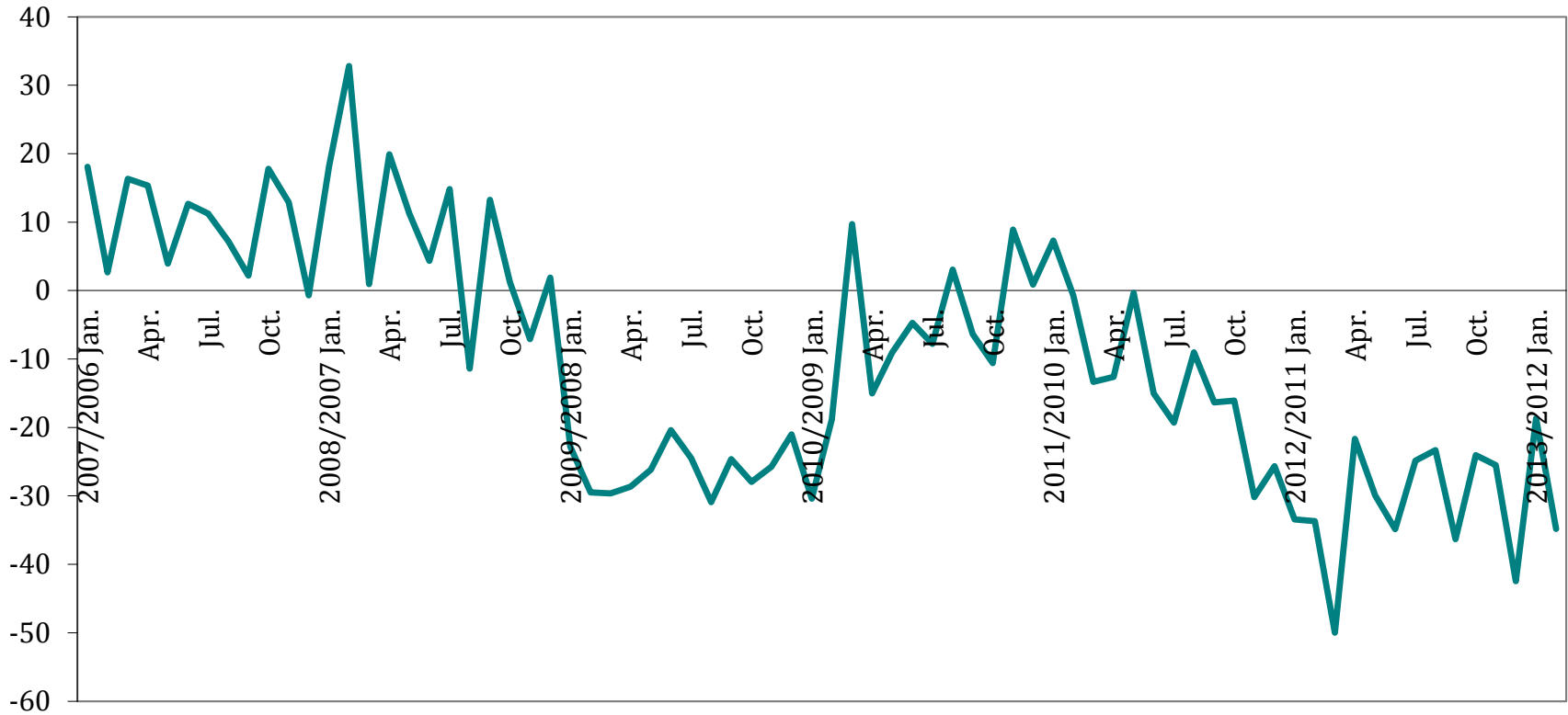
CREDIT TO PRIVATE SECTOR - CONSUMER CREDIT (annual change %)



Source: CBC

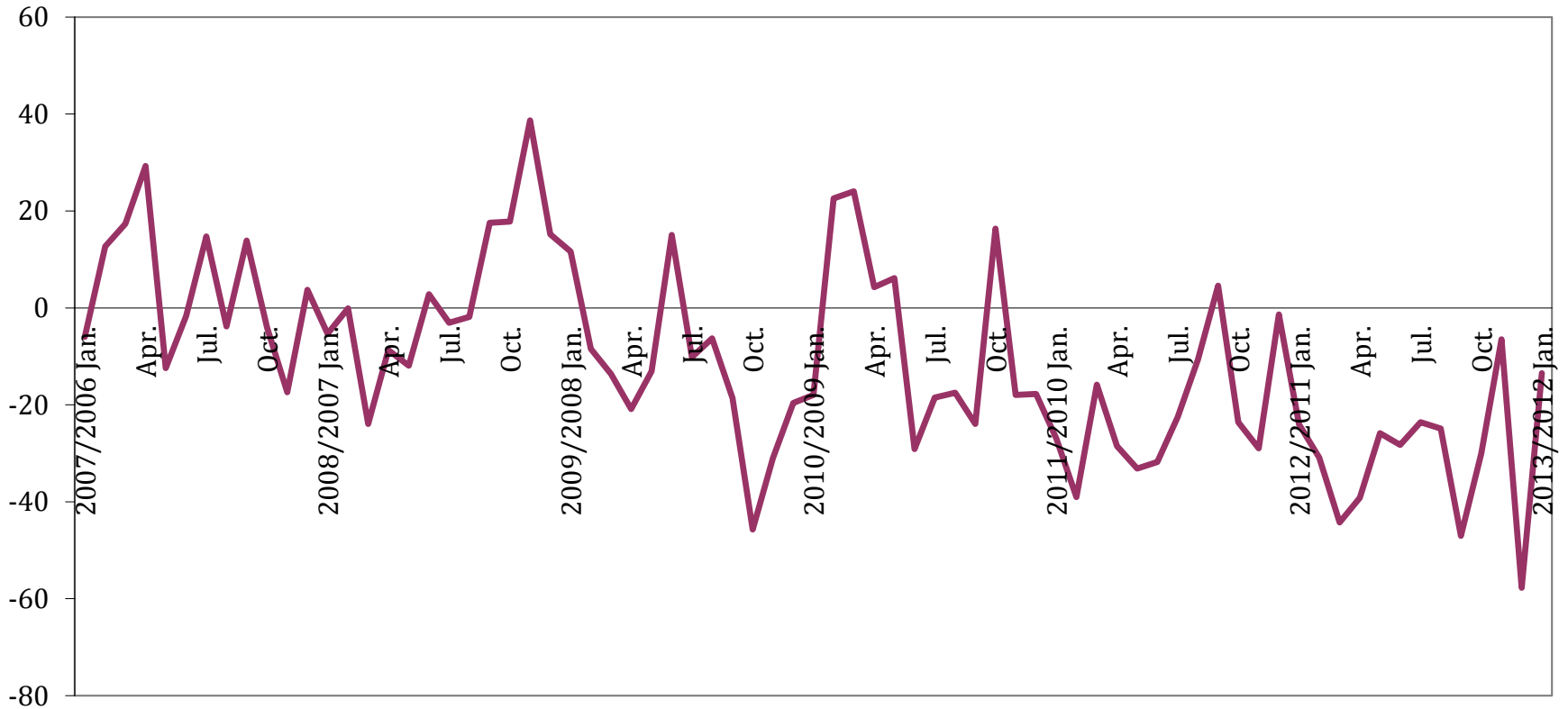
Credit growth has decelerated, from high levels - lending rates exhibiting a downward trend

CEMENT SALES (annual change %)



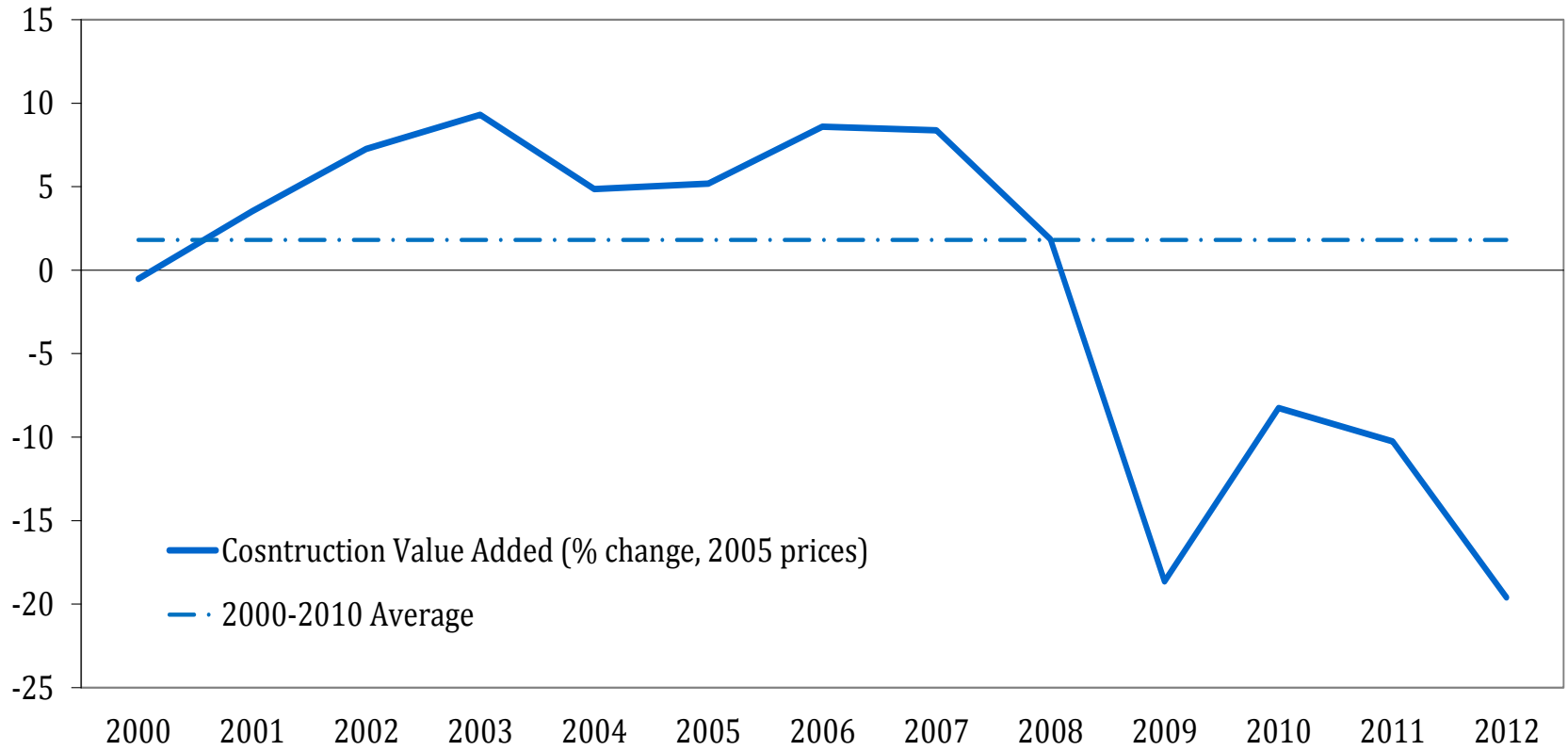
Depressed conditions in the construction sector

BUILDING PERMITS (Area m²) (annual change %)

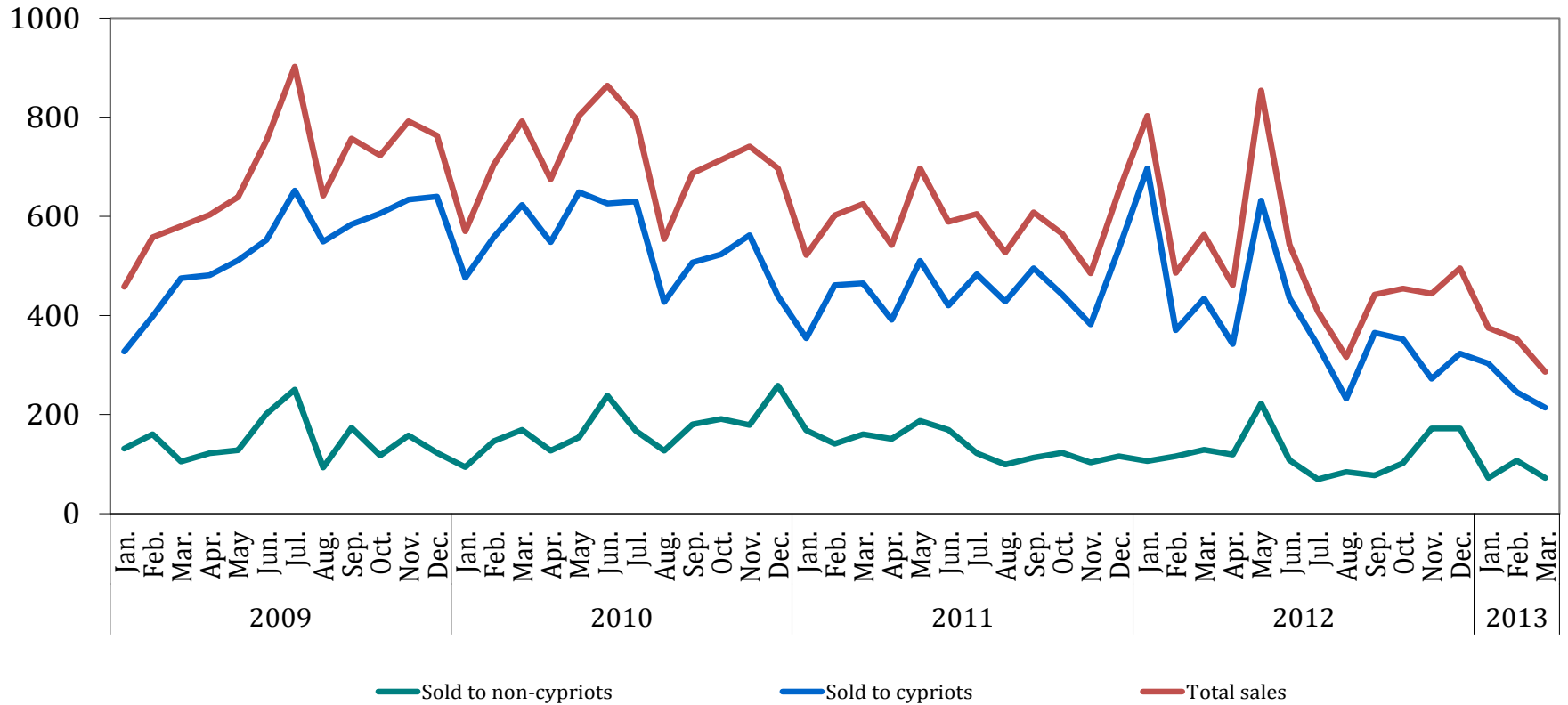


Further correction expected in the medium term - housing more affected

Construction

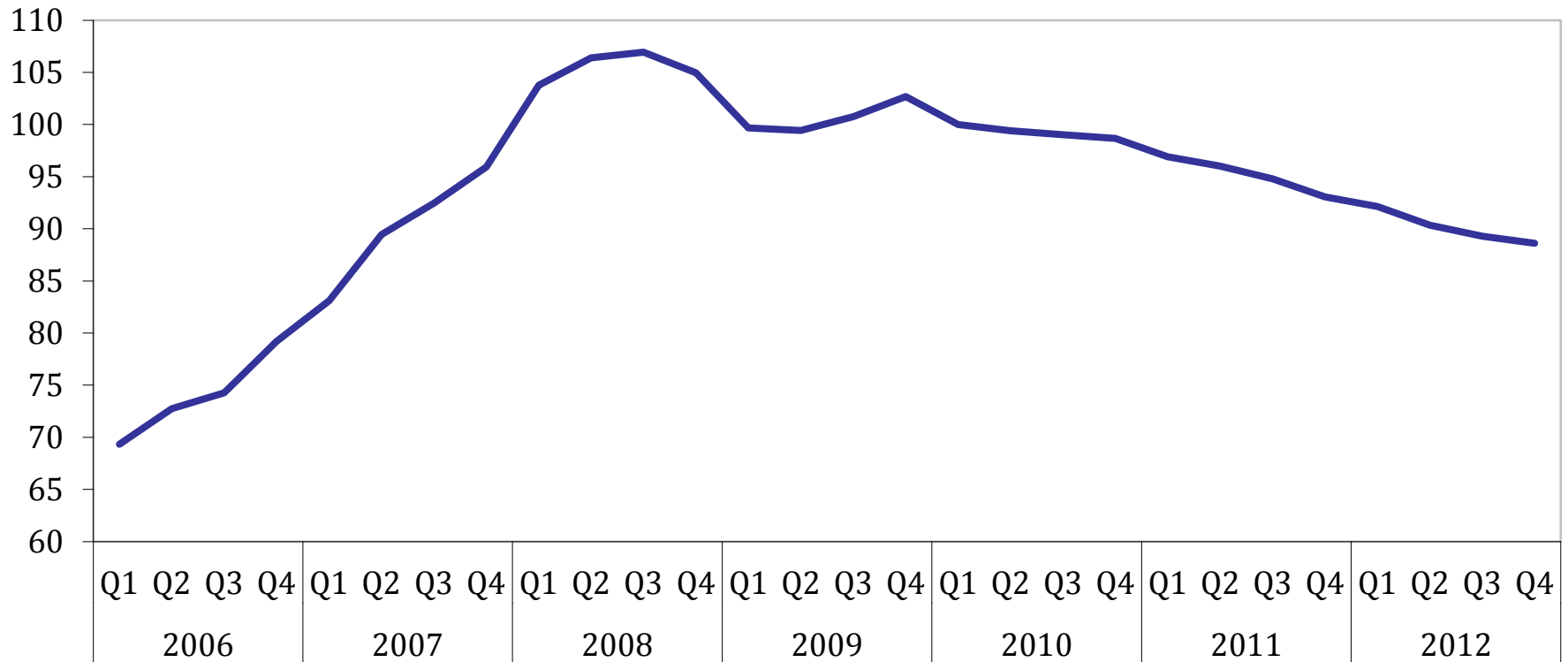


Sales of Property (number of new sale contracts)



Both local and foreign demand suppressed

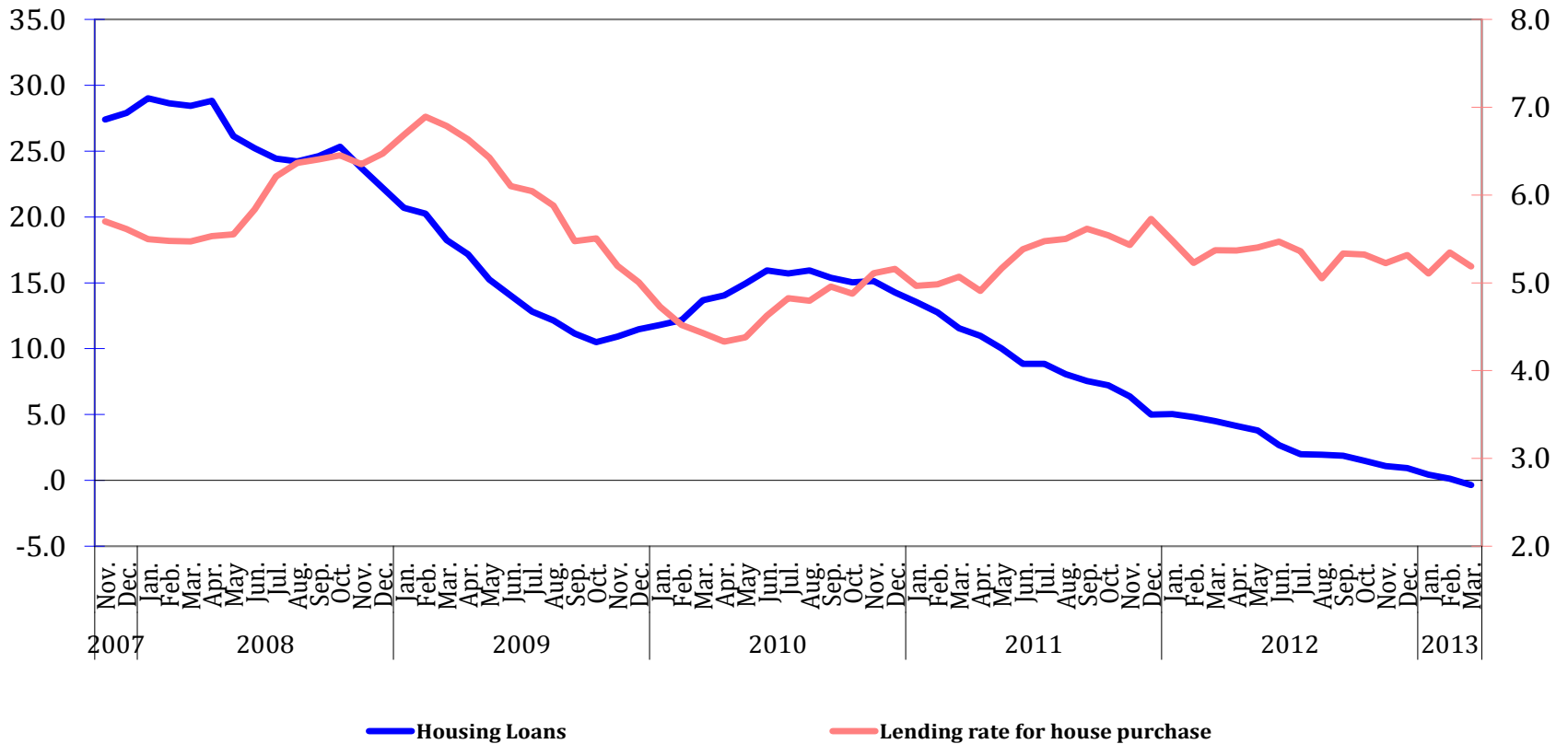
Housing Price Index (2010Q1=100)



Source: CBC

Prices adjust to demand conditions but in a moderate way

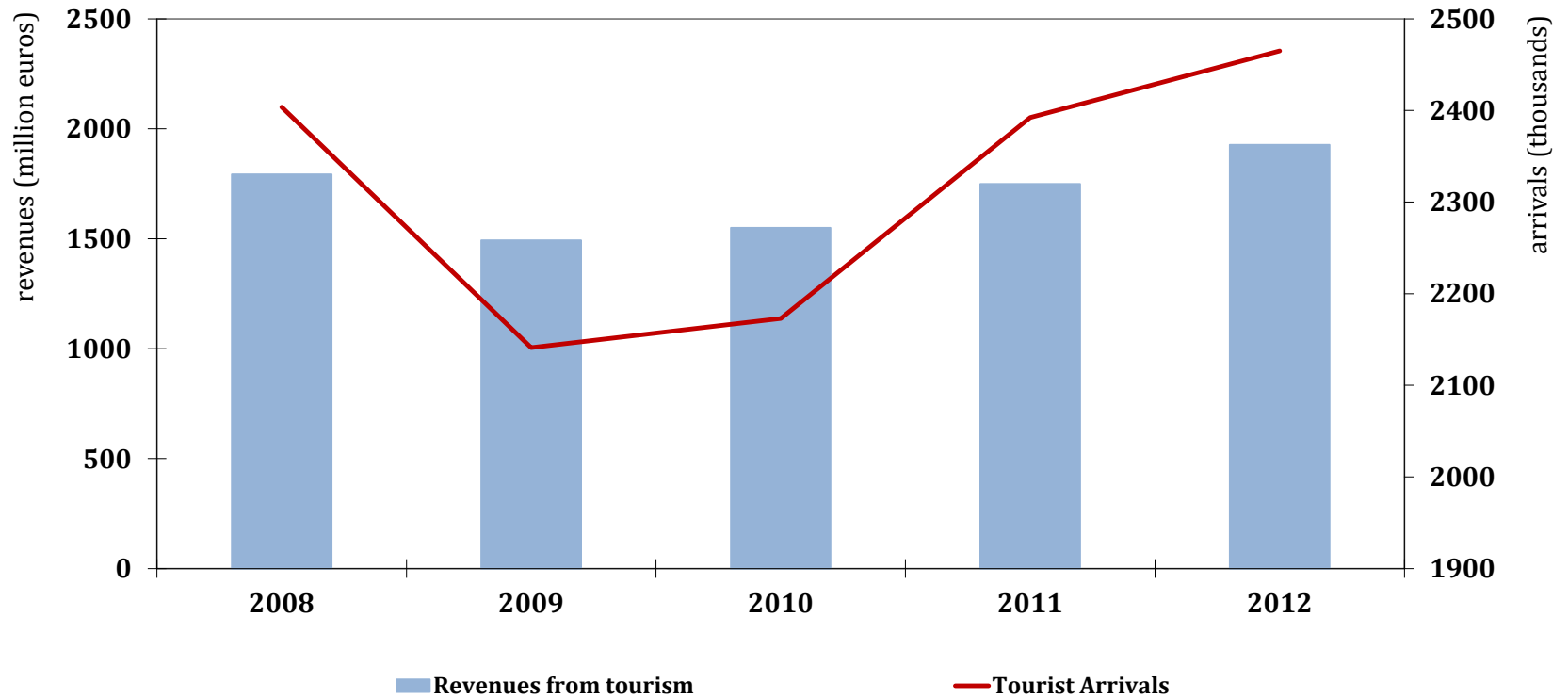
CREDIT TO PRIVATE SECTOR - HOUSING LOANS (annual change %)



Source: CBC

Substantial cuts in new lending to construction – declining trend of interest rates

REVENUES FROM TOURISM AND TOURIST ARRIVALS



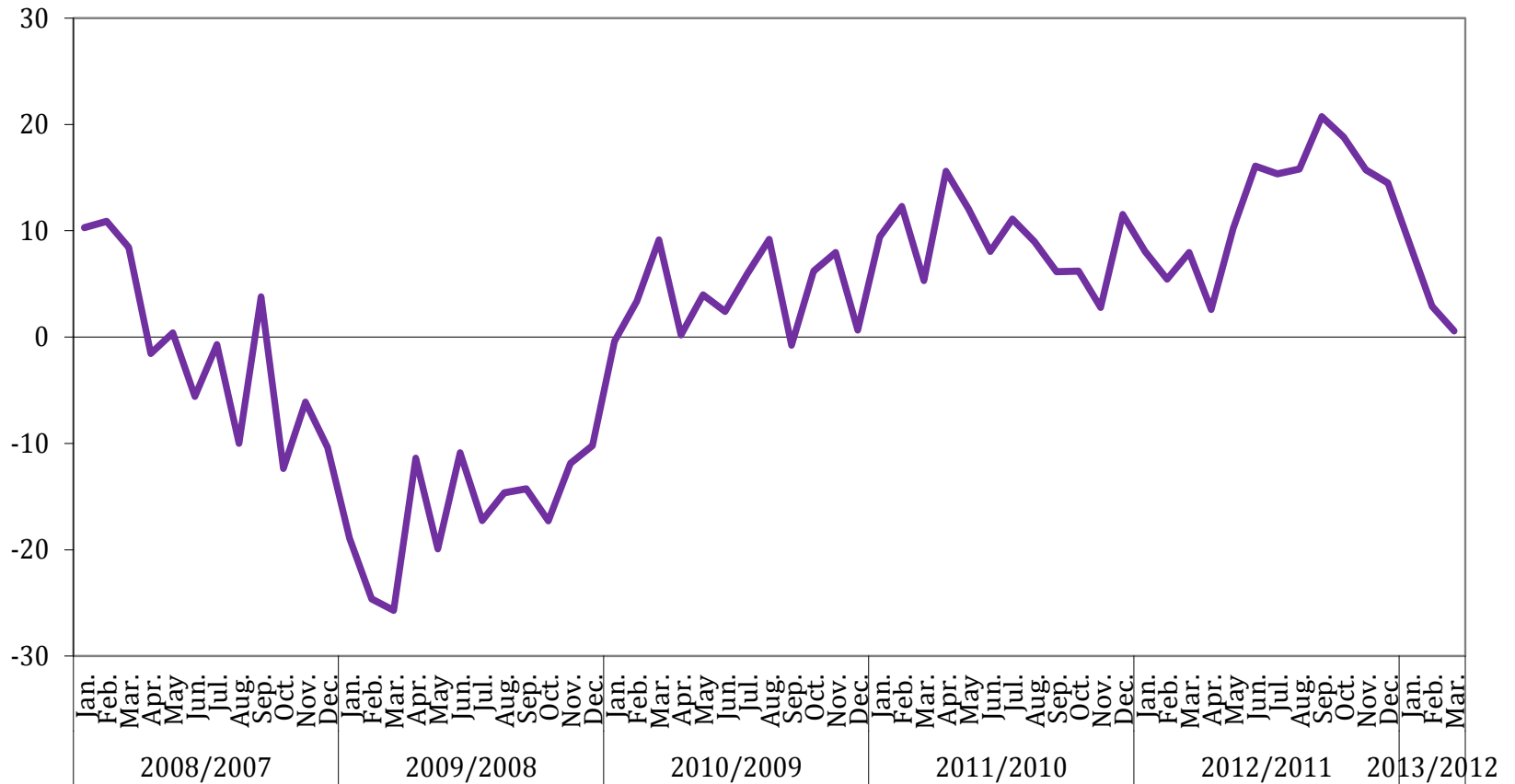
TOURIST ARRIVALS

<u>Tourism</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013/Q1</u>
Total	-10.9	+ 1.5	+ 10.1	+3.0	-10.2
United Kingdom	-14.0	-6.8	+2.5	-6.0	-2.9
Greece	-0.9	-3.2	+8.7	-4.1	-8.0
Germany	-0.7	+6.1	+13.4	-8.5	-39.5
Russia	-17.8	+50.5	+49.2	+42.0	-3.6

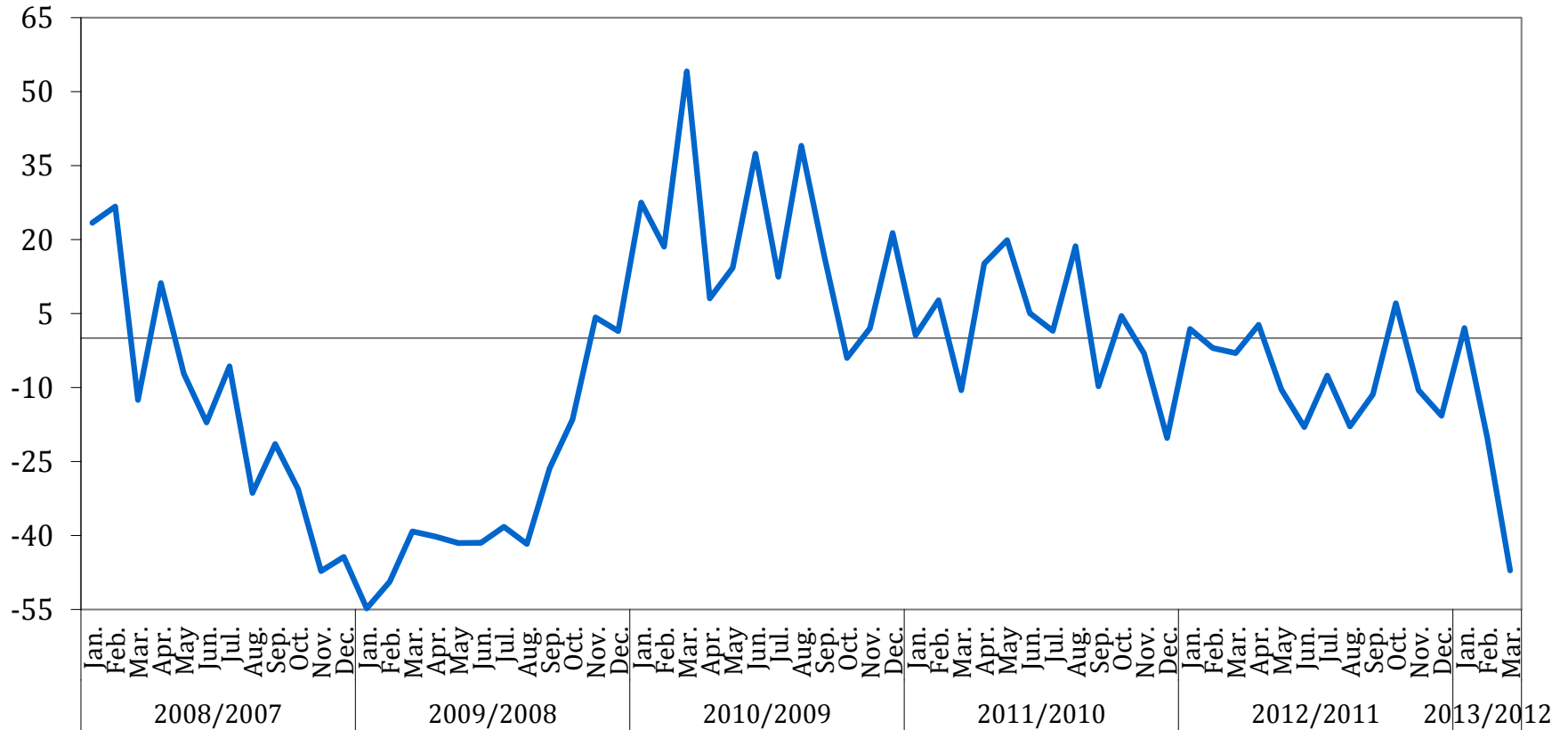
Tourist arrivals by country of origin. Notwithstanding decline in Q1, encouraging signs from some markets (Russia).

According to Cyprus Tourism Organization, an increase in arrivals of around 2%-3% may be expected for 2013 but downside risks.

Non Resident credit card transactions (annual change %)



Registration of New Companies (annual change %)

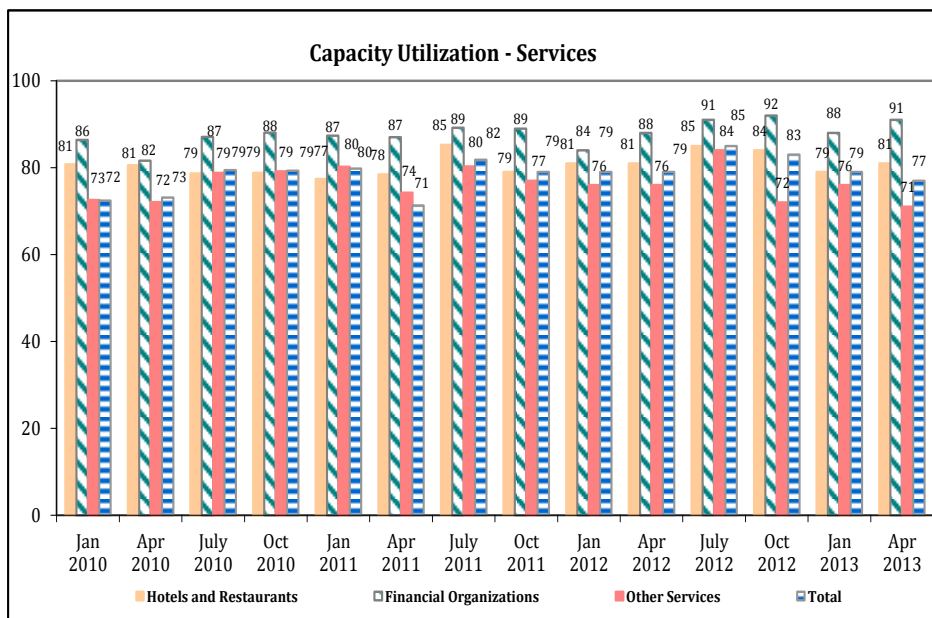
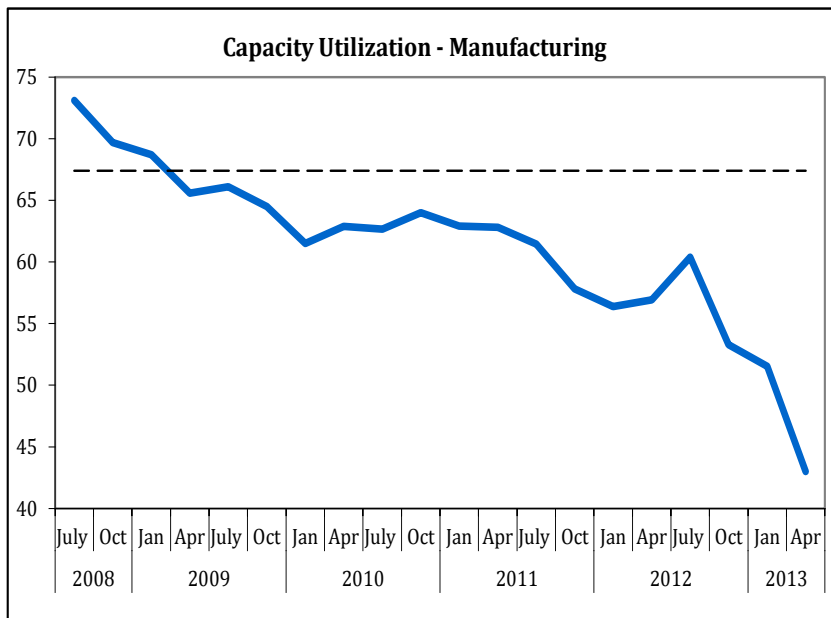


Declining trend – however no evidence of international companies leaving Cyprus, to the extent anticipated

Services Value Index

	2009/08	2010/09	2011/10	2012/11
Information and Communication	-1.9	+4.7	+3.7	-0.4
-Publishing	-2.3	+0.6	+2.9	-12.7
-Telecommunication	+0.4	+3.7	+6.3	-0.3
-Computers	-10.3	+13.4	-1.0	+20.8
-Information Services	-2.2	+21.3	+17.3	+2.7
Hotels and Restaurants	-3.6	+5.1	+6.4	+2.6
Professional Services	+0.8	+3.2	+5.0	-4.0
-Architects etc	-4.8	+0.7	-5.1	-20.0
-Legal, accounting, auditing etc	+3.1	+6.2	+8.4	+0.2
Administrative and Supportive Services	-15.4	+10.5	+1.5	+0.1

Developments in the services sector are mixed. In some subsectors, growth still in the positive territory

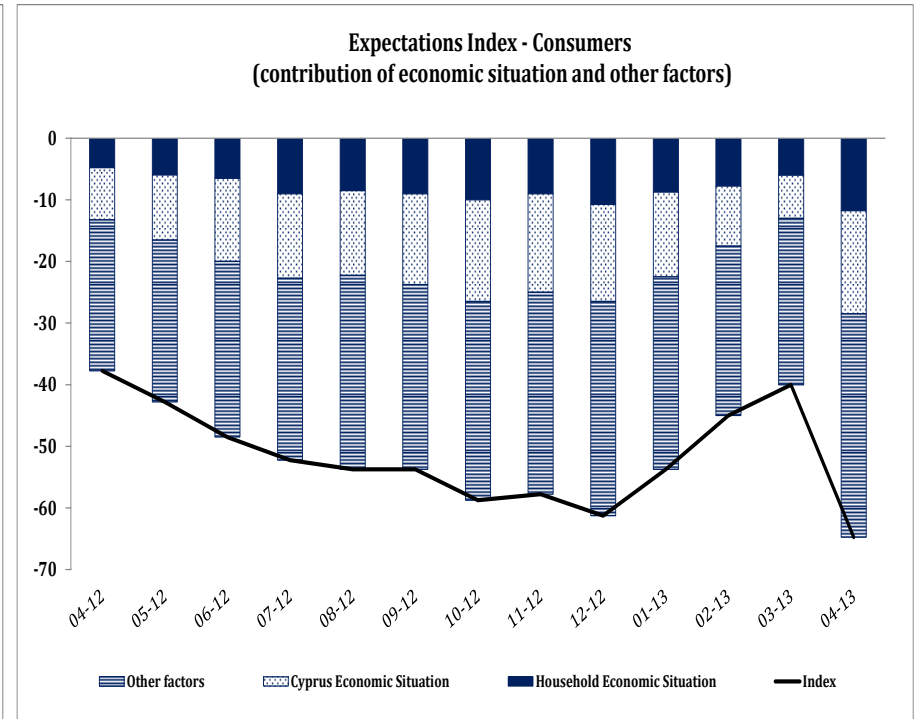
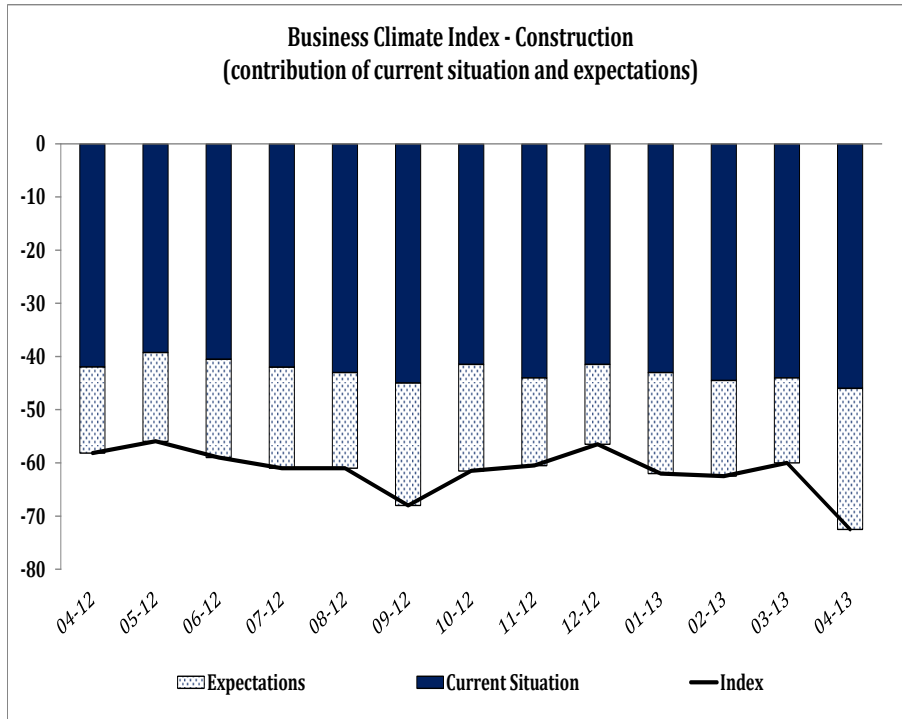


Source: Economics Research Centre

Note: Revised calculation method

Capacity Utilization in Manufacturing & Services – an indication of low pressures on core inflation

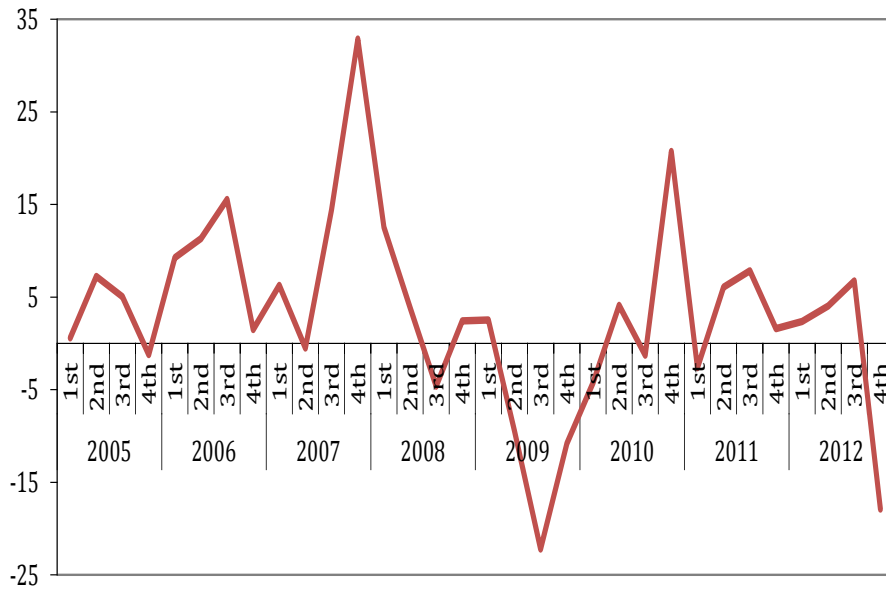
Construction and Consumers sentiment



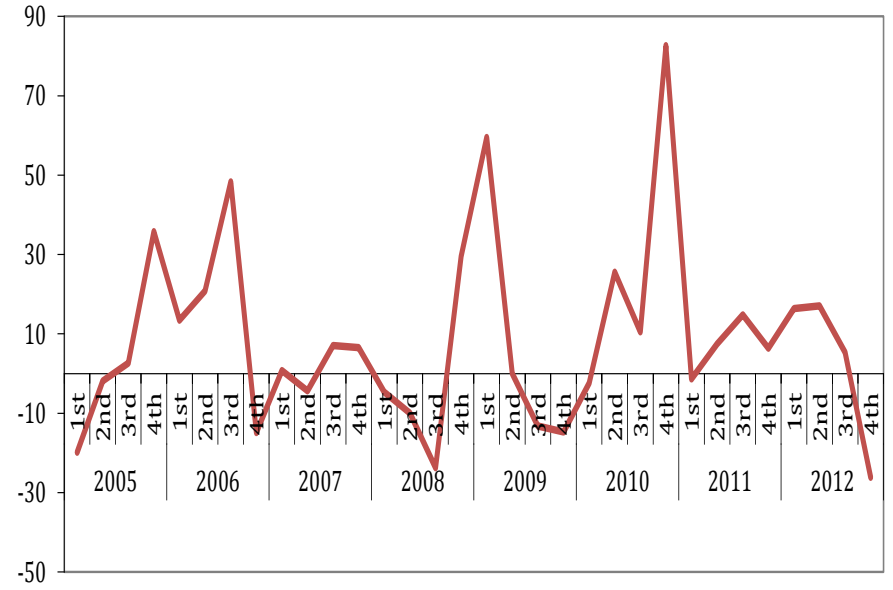
Source: Economics Research Centre

Exports of services

EXPORTS of SERVICES (nominal)
Annual change (%)

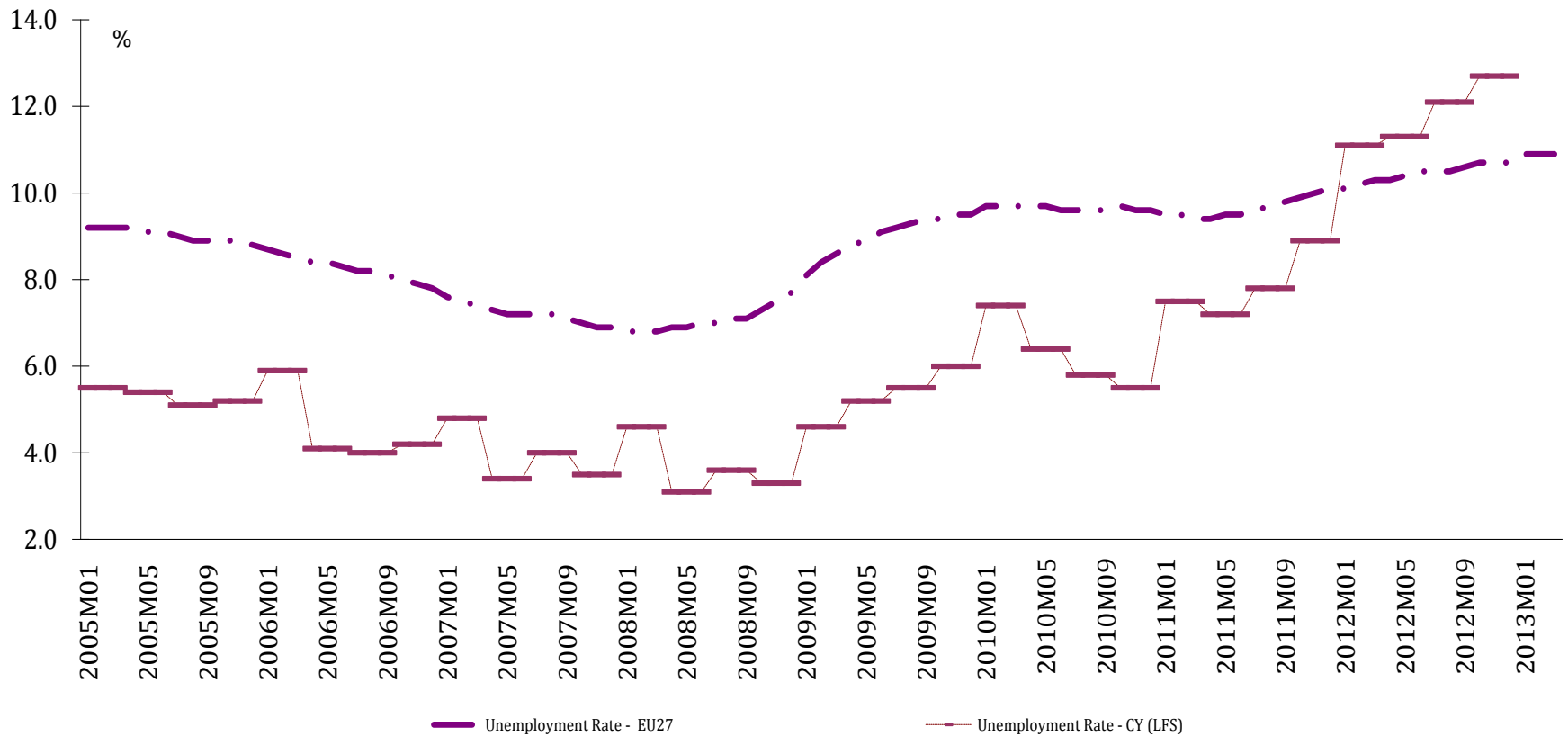


EXPORTS of OTHER BUSINESS SERVICES (nominal)
Annual change (%)

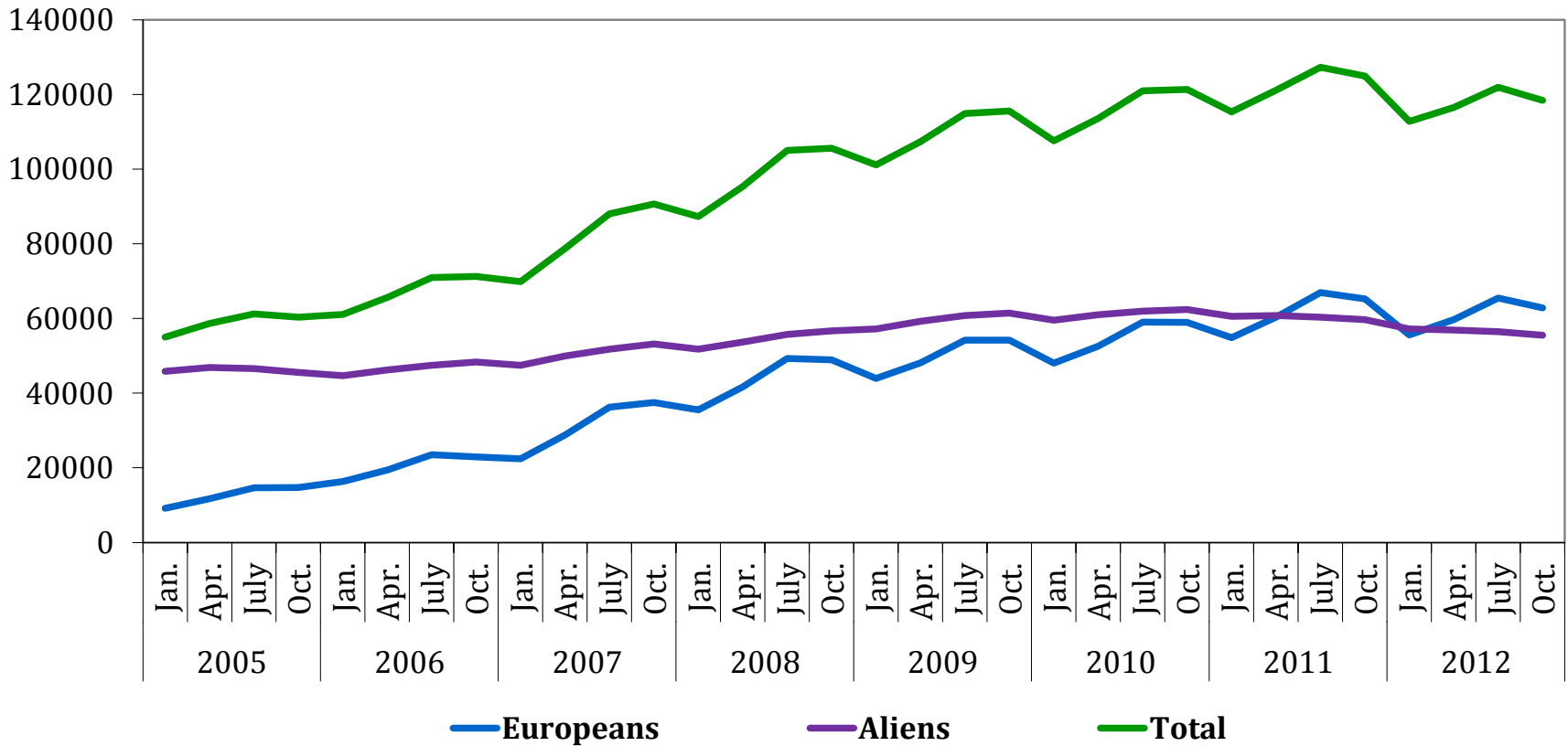


Source: CBC

Unemployment upward trend



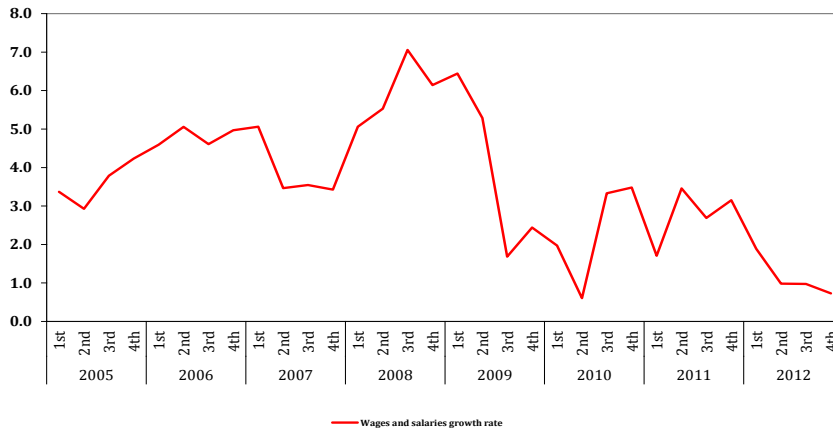
Employment of Foreigners in Cyprus (persons)



Employment of Foreigners adjust to bleak growth outlook

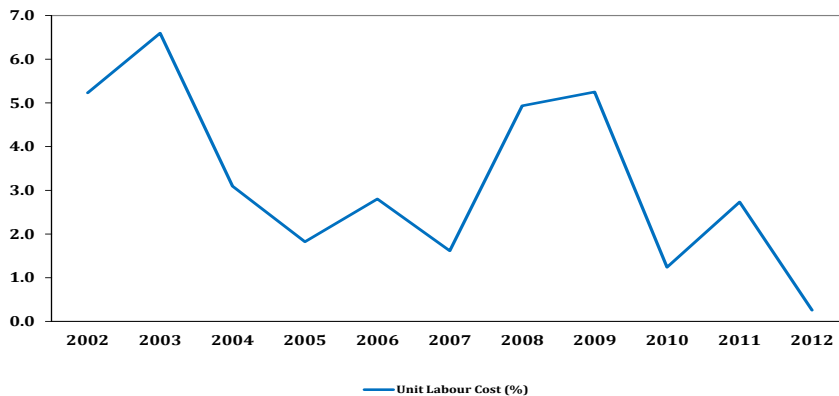
Wage Developments

WAGES AND SALARIES GROWTH RATE
Annual change (%)

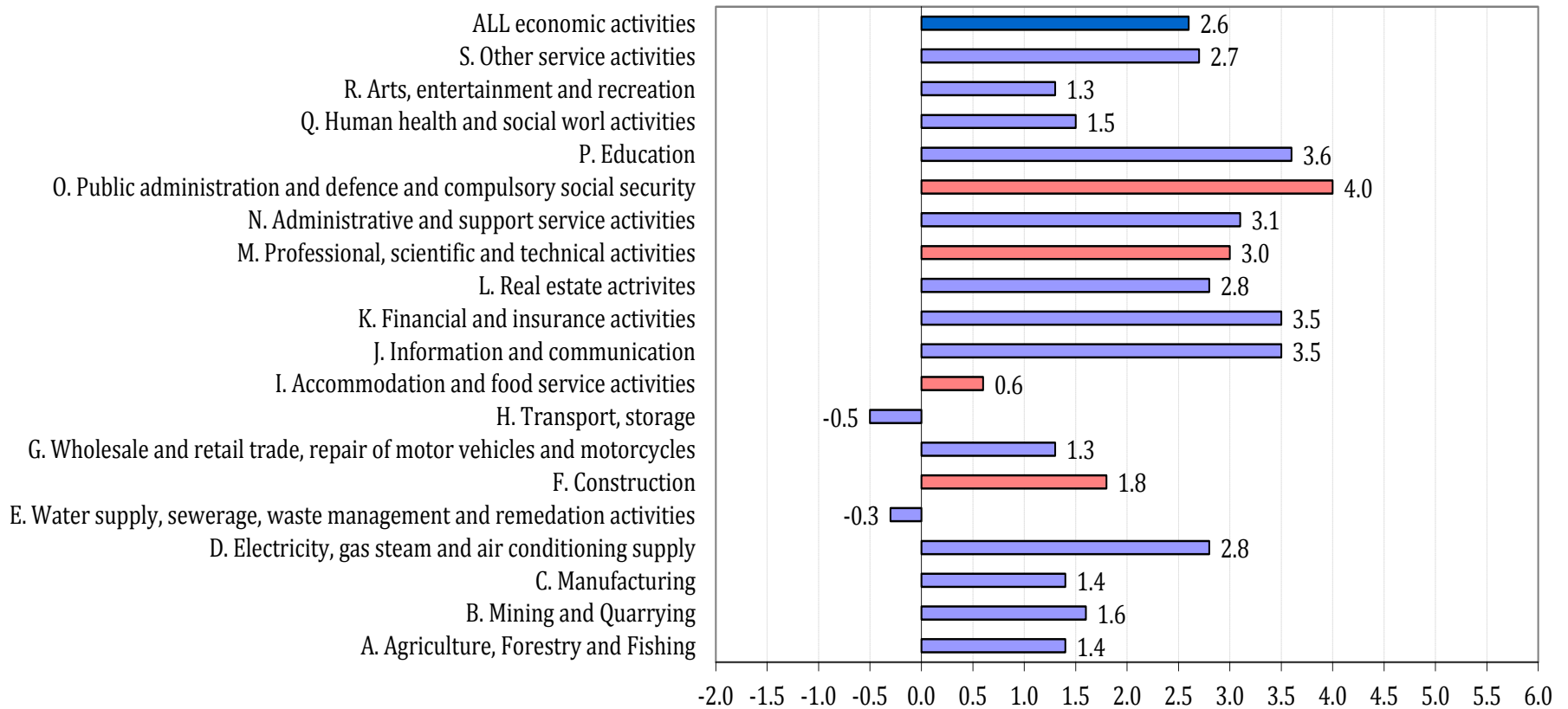


- Nominal wages growth $\approx 1.1\%$ in 2012
- Sectoral variations
- Wage moderation after 2010
 - Public sector wage cuts likely to spill over in other services
 - Weaknesses in some sectors exerted downward pressure on wages
- COLA reform
- Contribution of foreign workers continues to be significant in controlling costs in recent years

ULC
Annual change (%)



Nominal Earnings - 2011/2010 change (2009=100)



Minimum Wages

- Minimum wage increases generally faster than national median income.
- The ratio of minimum wage with respect to the national median income remained roughly stable since 2007.

Year	Minimum wage(€)	% change	National median income (€)	% change	Ratio of mimimum income to national median income
2006	697		1464		47,6
2007	742	6,4	1519	3,7	48,8
2008	789	6,4	1621	6,7	48,7
2009	840	6,5	1670	3,0	50,3
2010	887	5,6	1750	4,8	50,7
2011	909	2,5	1819	3,9	50,0

Memorandum of Understanding («MoU»)

MOU

- After intensive discussions, an agreement was reached on the 25th of March 2013 at Eurogroup level for the provision of financial assistance to Cyprus
- Assistance up to 10 billion, 9 billion from ESM and 1 billion from IMF
- Ambitious full Macroeconomic Programme covering the period until 2016
- Measures under three main pillars:
 - Banking sector
 - Public finances
 - Structural measures

MOU - Structural Measures

- There are a number of important Structural Measures included in MOU· their implementation is expected to address a number of structural weaknesses of the economy - contribute to economic growth

Structural Measures cover the areas of:

- Labour market reform
- Pension reforms
- Enhancement of Budgetary Framework
- Health care sector reform, including revising the free access to health care, increase fees for medical services, introduce co-payments
- Reform of the public sector in order to become more effective – change of working times, reduce impediments to staff mobility. Independent external review for further reforms will take place.

MOU - Structural Measures (cont'd)

- Improvement of the regulatory framework for the creation of Public-Private partnerships.
- Privatisations of state-owned enterprises and semi-governmental organizations, to improve economic efficiency through enhanced competition.
- Immovable property tax reform so that to improve the fairness of tax burden, includes the implementation of property price index and conduct of studies for further reforms.
- Restructuring of the Welfare system, including streamlining the number of benefits, better targeting etc.
- Strengthening revenue administration. Improving revenue collection by modernizing revenue administration will help to maximize fiscal revenues. Inland Revenue Department and the VAT Services, have agreed to finalize a reform strategy by end-June.

Labour Market structural reforms

- Recently adopted a reform of the cost of living adjustment public wage indexation system (COLA) allowing for partial (rather than full) indexation of public wages and its automatic suspension during recessions expected to reduce the high public wage bill and moderate private wages, contributing to an improvement in Cyprus' competitiveness.
- COLA will not be paid to employees before 2016 containing increases in nominal wages, reducing employment cost and thus, improving labour market conditions.

Labour Market structural reforms

- Restriction of adverse competitiveness effects by maintaining minimum wage at its current level. Any change in the **minimum wage** should be in line with economic and labour market developments that will take place only after consultation with programme partners.
- Planned reform (Q2-2013) of **public assistance** to reduce disincentives to work and imposing job search requirements for continued benefit receipt and provide an assessment of current activation policies by Q2-2013.
- Review and enhance cooperation between PES and the benefit-paying institutions in the activation of the unemployed.
- Downward adjustment of wages.

Pension Reform

- A parametric pension reform was introduced in January 2013, which has significantly improved the long-term viability of the pension system. It was agreed that an actuarial study is needed to assess the effect of the recent pension reforms on the financial viability of the general pension system and the expected net budgetary cost of the public pension system. Based on this assessment, additional reform measures may need to be developed in future reviews with the aim to ensure the financial viability of the systems through 2060, which will help to preserve long-run fiscal sustainability in the face of population aging.

MTBF

- An MTBF law compliant with EU requirements was approved in December 2012. It has been agreed to finalise secondary legislation and regulations to have the MTBF fully in place for the 2014 budget, as well as to submit to Parliament a fiscal responsibility and budget systems law to support the MTBF and address other existing legal shortcomings.

Medium-term Framework

Medium-term Framework

- Following a significant contraction of output in 2013 and 2014, growth is expected to rebound in 2015 and attain 2% over the medium term.
- Unemployment picked up further in 2012 – expected to continue to increase and remain at high levels and fall in 2015.
- Core inflation stable around 1½-2%, headline rate dominated by oil effects, food prices and taxation.
- Current account deficit: expected gradual improvement conditional to anticipated improvement of public savings-investment balance (fiscal consolidation) and improvement of private savings-investment balance (low increase of private consumer credit, subdued growth in construction) & normalization of income account.

Base Scenario

	2012	2013f	2014f	2015f	2016f
Real GDP (%)	-2.4	-8.7	-3.9	1.1	1.9
Unemployment (%)	11.8	15.5	16.9	14.6	13.7
HICP Inflation (%)	3.1	1.0	1.2	1.6	1.7
Current Account Deficit (% of GDP)	-11.7	-2.0	-0.6	-0.9	-1.0

Growth Drivers

- International business continues to be a driver of growth due to Cyprus competitive advantages.
- Market evidence reveal that effects of haircuts on deposits in Laiki and Bank of Cyprus on international business are less pronounced than expected.
- **Reasons for resilience:**
 - Historical, ties with main markets, such as Russia and Ukraine
 - More than 20 years of experience in international business
 - Well developed and dynamic industry of over 500 organisations supporting international businesses (large accounting firms, legal firms etc)
 - Tax environment
 - Proven and modern Infrastructure for International Businesses

Growth Drivers (cont'd)

- **Gas Exploration and Exploitation** - Estimated expenditure in investments for the period 2013-2020: €24.7bln - €2.2bln expected to have a positive contribution to Cyprus economy (20% of total expenditures in the case of Exploration and 8% in the case of Exploitation activities) – in terms of GDP (based on 2012 GDP), average impact for whole period estimated at 1.5%: 0.2% in 2013-2014, reaching 1.1-1.4% in 2015-2017 and 2.5-2.8% in 2018-2020.
- **Tourism** - Evidence that dynamism in tourist arrivals will continue in 2013 – efforts to improve cost competitiveness will contribute positively
- **EU Funds** - Utilization of the expected increased and more targeted EU funds

Gas Exploration and Exploitation (1)

- Cyprus has already adopted an 'in principle' decision at a political level, to go ahead with the development of a liquefaction plant onshore Cyprus for the production and export of LNG.
- All necessary upstream infrastructure for the field development, gas extraction and production/processing, and gas transfer to shore will be developed in parallel.
- A relatively small portion of the indigenous production will be used for local consumption, mainly in the power generation sector.
- Substantial progress in negotiations with our neighbors Israel to develop the sector.

Gas Exploration and Exploitation (2)

- Investments in infrastructure related to natural gas findings expected to support growth - Currently planned infrastructure includes:
 - Installation of an upstream production platform and related subsea equipment – 2015-2018
 - Development of a subsea pipeline from Block 12 to the shore (Vasilikos Area) – 2015-2018
 - Construction of a natural gas liquefaction and LNG export terminal – 2015-2019
 - Preliminary studies have indicated an approximate cost ($\pm 25\%$) of 9.14 billion USD (2012 prices) for two trains with a production capacity of 5 million tonnes per annum each and 6.03 billion USD (2012 prices) for one train with a production capacity of 5 million tonnes per annum.
 - Internal gas transmission network development – 2015-2018
 - The initial network will consist of three pipelines that will supply the three Power Stations in Cyprus and will serve as the backbone for the development of the future domestic and industrial gas distribution network.
- Positive spill over effect on services
- Lower energy prices
- Exports expected after 8-10 years

Growth Measures

- The Government has very recently announced a series of growth measures which do not have, in their majority, a significant budgetary impact.
- The measures cover (a) vulnerable groups (b) employment (c) development (d) environment (e) social policies (f) education.
- It has also announced a 2nd package of measures for the modernization of institutions and of the state.

Policy challenges – Structural reforms

- Adjustments of wages.
- Recapitalization of banks – restoration of lending to the economy.
- Public sector reforms – organizational streamlining.
- Pensions: Reductions - new actuarial report.
- Social expenditures: expenditure review - efficient targeting.
- Reorganization of the National Health System.
- Tax system: based on low tax rates, wide tax base and has served us well – no plans for reform – but tax administration reform.
- Privatisations.

Conclusions

- Uncertainty reinforced by events
- Low growth environment
- Investment in infrastructure (related to natural gas), net exports expected to dampen downward impact on growth
- Unemployment to remain elevated
- Wage moderation – positive effects on competitiveness
- Core inflation declining trend
- C/A deficit to moderate
- Fiscal challenges
- Strong commitment to implement MOU, and growth package