# Cyprus: Macroeconomic Outlook

October 2013

# Presentation

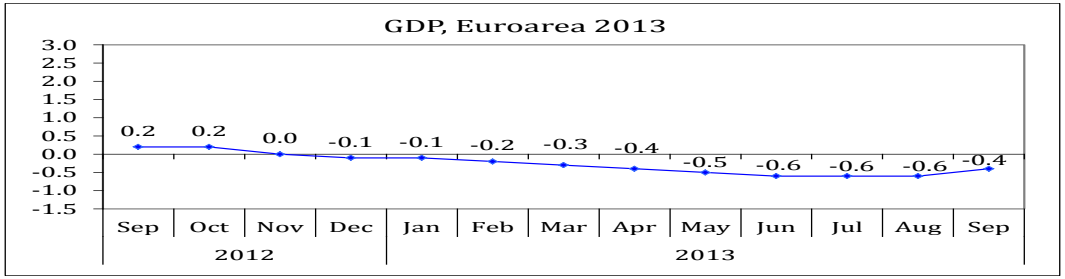
- Main messages
- Current situation
- Memorandum of Understanding
- Medium term macroeconomic framework
- Growth measures
- Conclusions

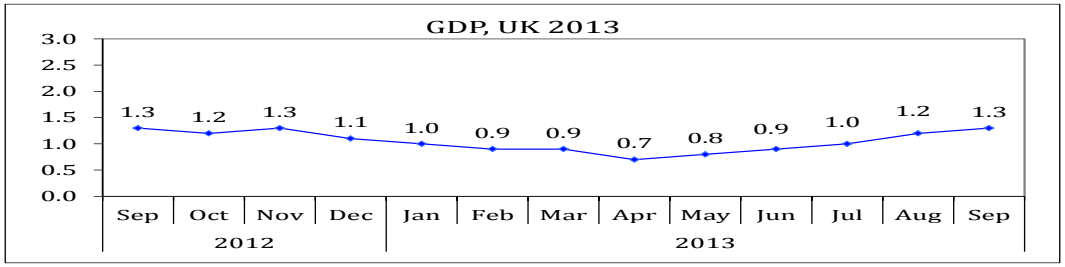
# Main messages

- April 2013, agreement of the Eurogroup on the MoU for Cyprus, supported by IMF
- … led to aversion of bankruptcy and aversion of exit from the Eurozone
- First Troika review mission positive: targets achieved, policies implemented as planned
- however challenges looking forward, in particular due to weak growth outlook – achievement of the MoU targets challenging
- … commitment of the Government 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 in the MoU, in conjunction with promising long term prospects in tourism as well as in the energy sector are expected to contribute to growth over the medium term

# Current situation

# External Environment



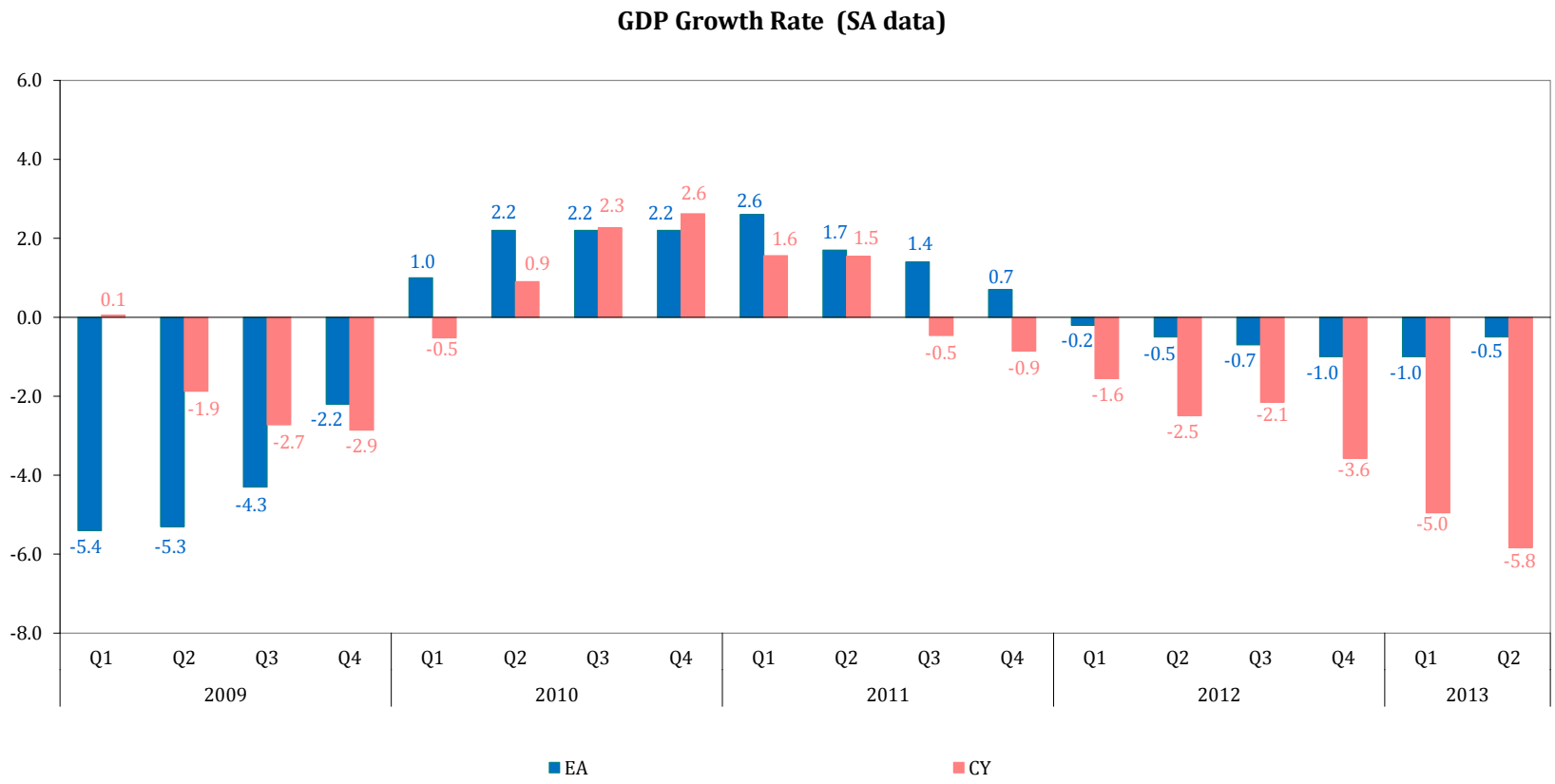
- Challenging external environment, critical for small open economies
  - some improvement but still weak prospects in the Eurozone, including Greece, UK
  - positive growth in Russia, however signs of slow down
  - opportunities for export of services in CEE, incl. Russia

Source: Consensus Economics Inc.

# Economy: Selected indicators

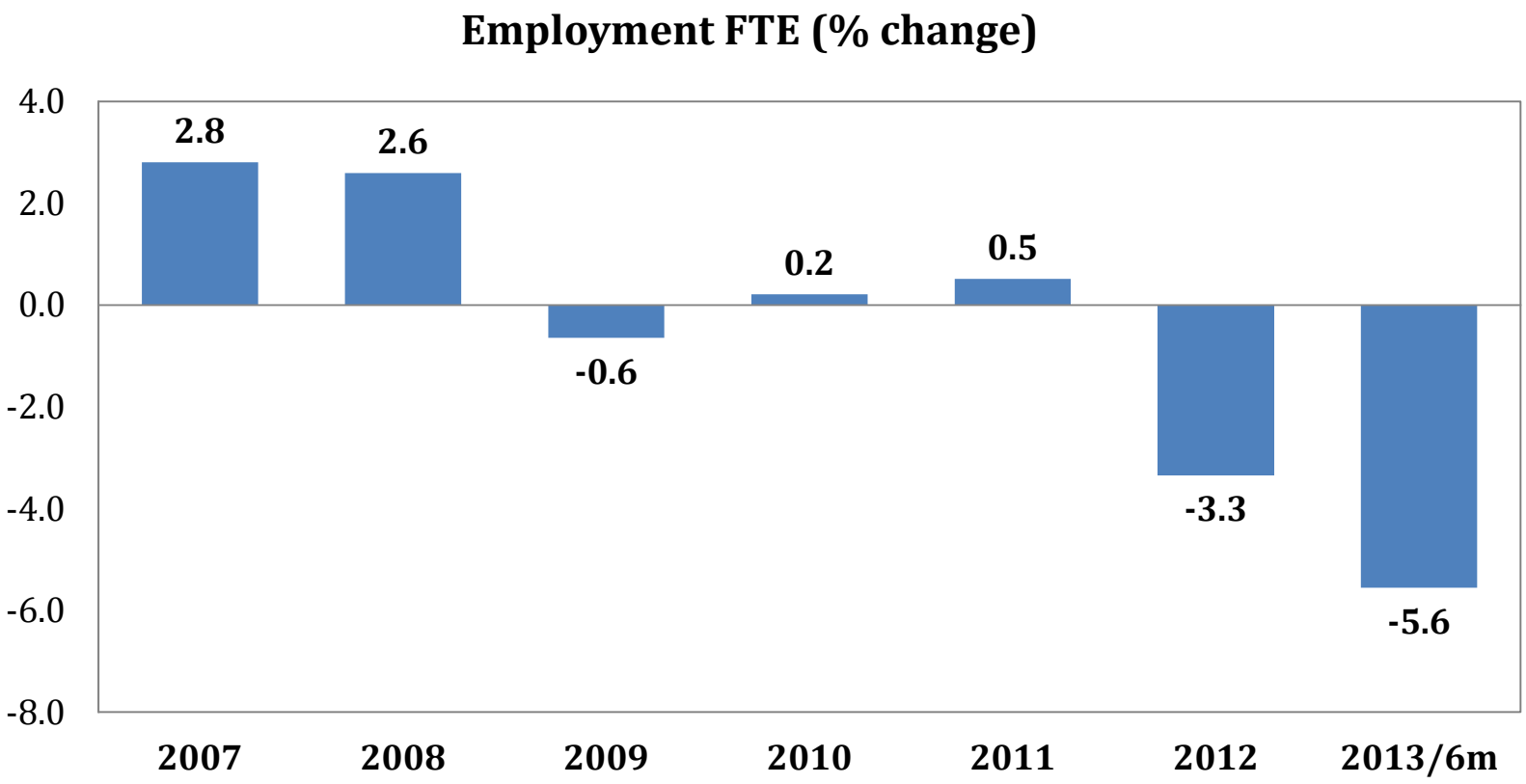
| *annual % change* | 2008 | 2009 | 2010 | 2011 | 2012 | 2013Q1 | 2013Q2 |
|---|---|---|---|---|---|---|---|
| GDP growth (constant prices)* | 3.6 | -1.9 | 1.3 | 0.4 | -2.4 | -5.0 | -5.8 |
| *Private consumption* | *7.8* | *-7.5* | *1.5* | 1.3 | -2.5 | *-5.2* | -6.0 |
| *Gross Fixed Capital Formation* | *6.0* | *-9.7* | *-4.9* | -8.7 | -19.6 | *-20.9* | -23.0 |
| *Exports* | *-0.5* | *-10.7* | *3.8* | 4.4 | -2.7 | *-6.1* | -6.3 |
| *Imports* | *8.5* | *-18.6* | *4.8* | -0.2 | -6.4 | *-13.9* | -21.2 |
| *GDP deflator* | *4.6* | *0.1* | *1.9* | 2.3 | 1.6 | *0.7* | -1.4 |
| Tourist arrivals (000's) | 2.403,8 | 2.141,2 | 2.173,0 | 2.392,2 | 2.464,9 | 177,2 | 746,9 |
| Tourist arrivals (%) | -0.5 | -10.9 | 1.5 | 10.1 | 3.0 | -10.2 | -6.2 |
| HICP (%) | 4.4 | 0.2 | 2.6 | 3.5 | 3.1 | 1.7 | 0.4 |
| Productivity growth** | 1.0 | -1.2 | 1.1 | -0.1 | 0.9 | -0.1 | 0.3 |
| Employment growth (FTE) | 2.6 | -0.6 | 0.2 | 0.5 | -3.3 | -4.9 | -6.1 |
| Nominal Earnings (%) | 6.0 | 3.9 | 2.3 | 2.8 | 1.7 | 0.4 | -1.6 |
| Unemployment rate (Labour Force Survey) | 3.7 | 5.4 | 6.3 | 7.9 | 11.8 | 15.9 | 15.5 |
| Trade balance of goods (% of GDP) | -32.4 | -25.5 | -26.8 | -24.3 | -21.8 | -4.6 | -3.9 |
| Trade balance of services (% of GDP) | 21.0 | 20.0 | 20.6 | 20.1 | 18.7 | 3.0 | 5.5 |
| Resource Balance (% of GDP) | -11.4 | -5.5 | -6.2 | -4.3 | -3.1 | -1.6 | 1.7 |
| Current account balance (% of GDP) | -15.6 | -10.7 | -9.8 | -3.4 | -6.9 | -2.8 | 1.9 |
| Fiscal Deficit (% of GDP) | 0.9 | -6.1 | -5.3 | -6.3 | -6.4 | 0.1 | -1.4 |

Sources: Cystat, CBC, MoF
*Seasonally adjusted data for GDP and components
**Calculated on non seasonally adjusted GDP data and FTE employment



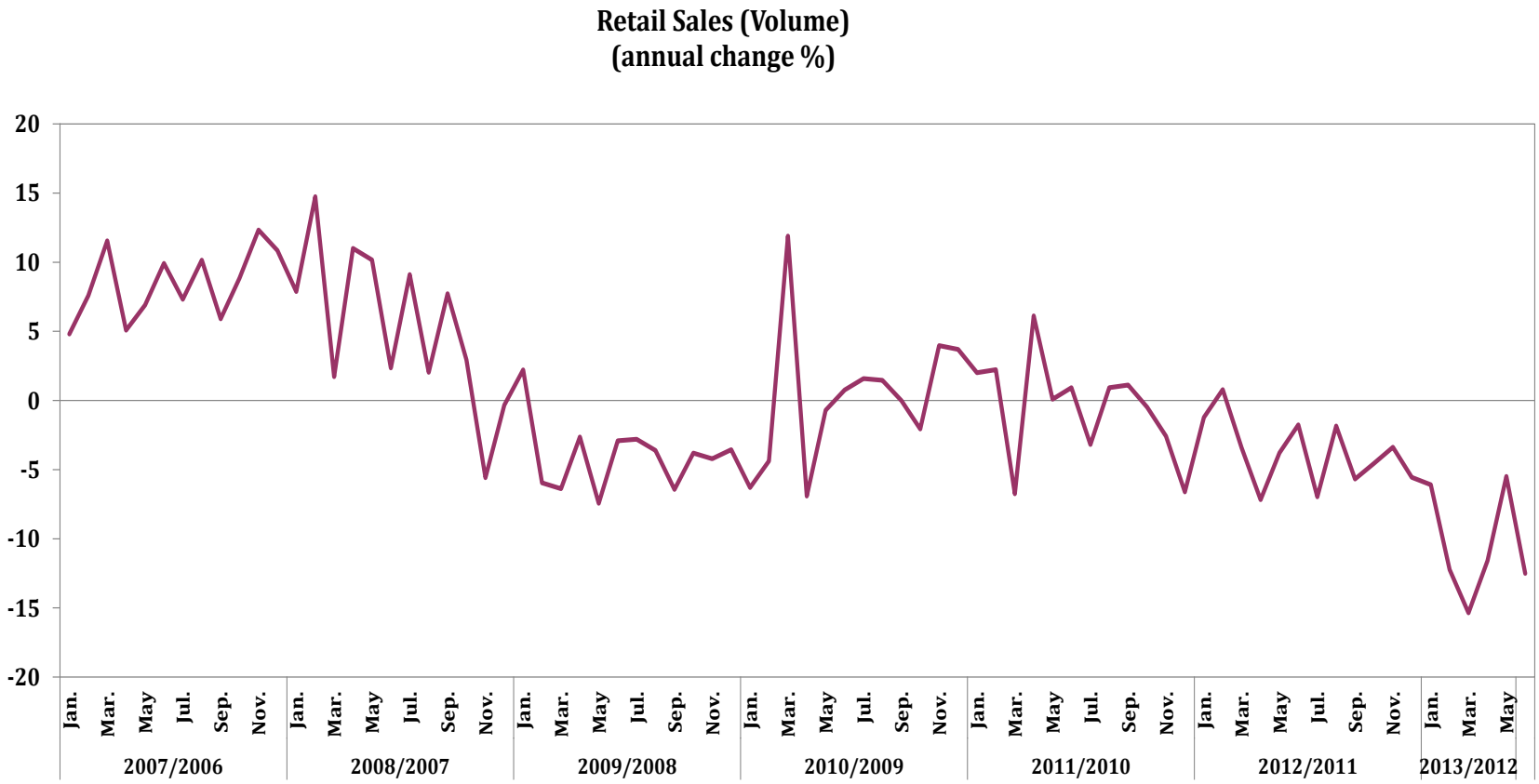

Source: Eurostat and Cystat

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



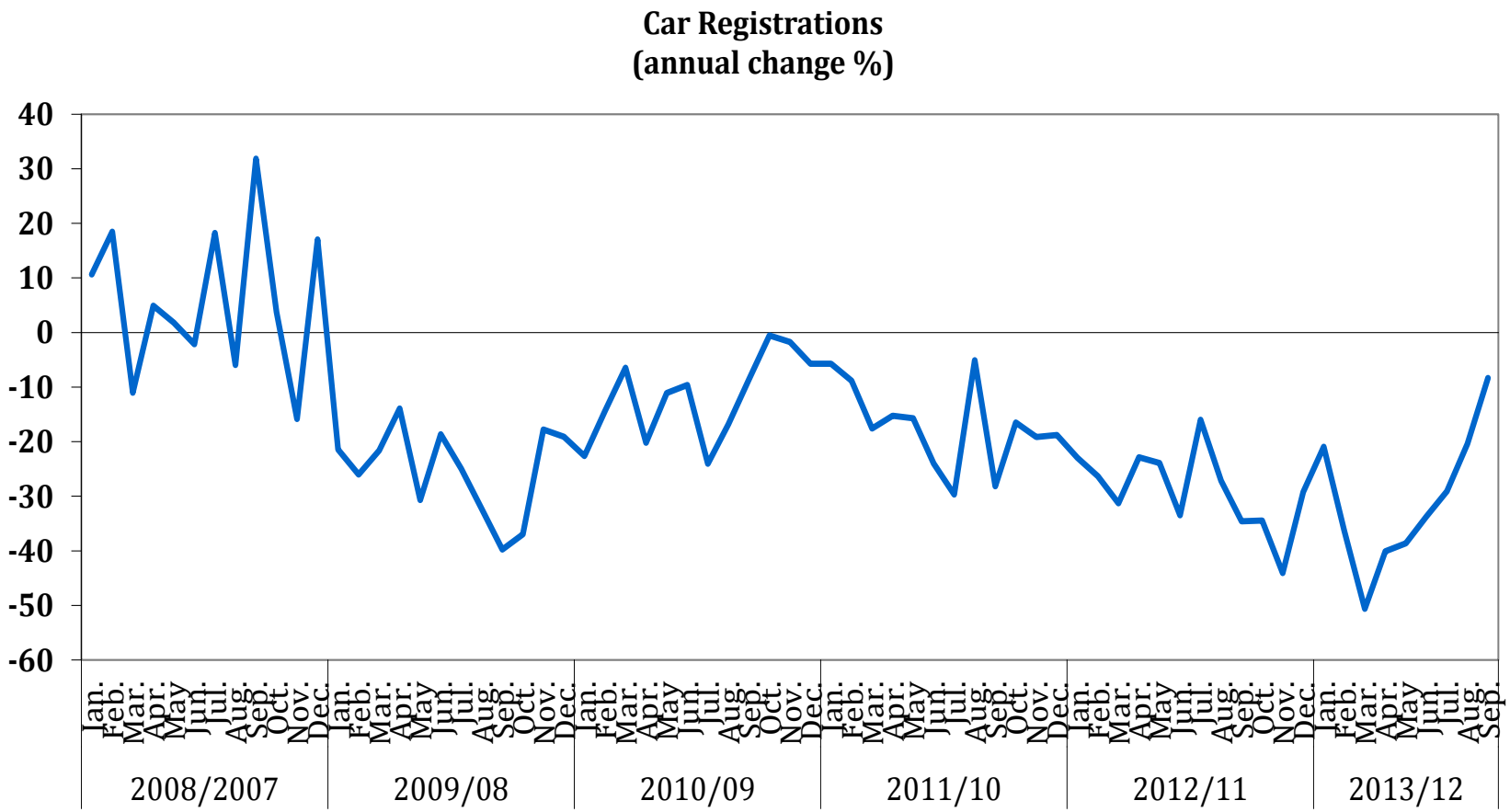

Source: Cystat

Weak growth outlook – effects on employment, including employment of foreign labour – exit from the labour market due to early retirement, migration may dampen supply and hence effects on unemployment.

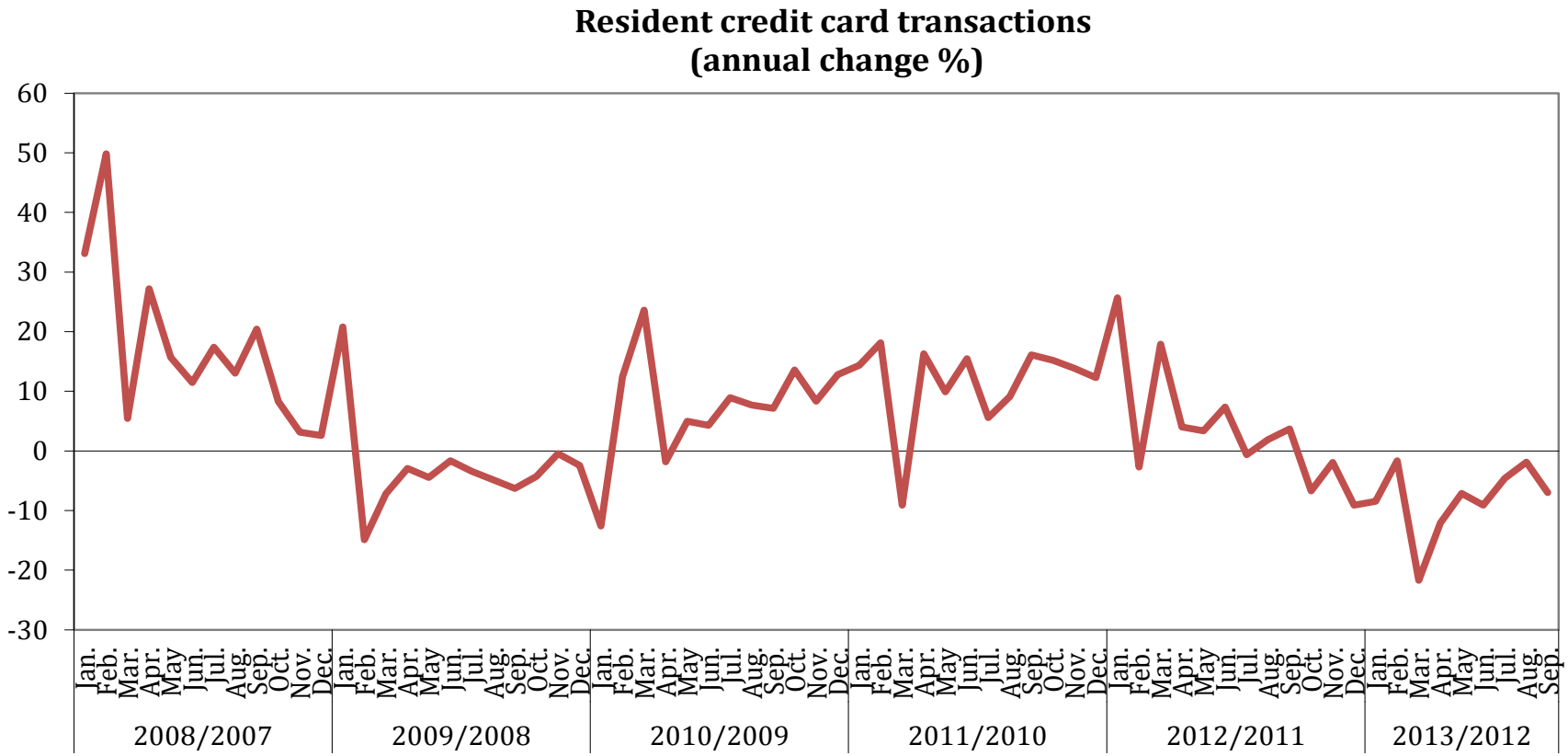



Source: Cystat

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

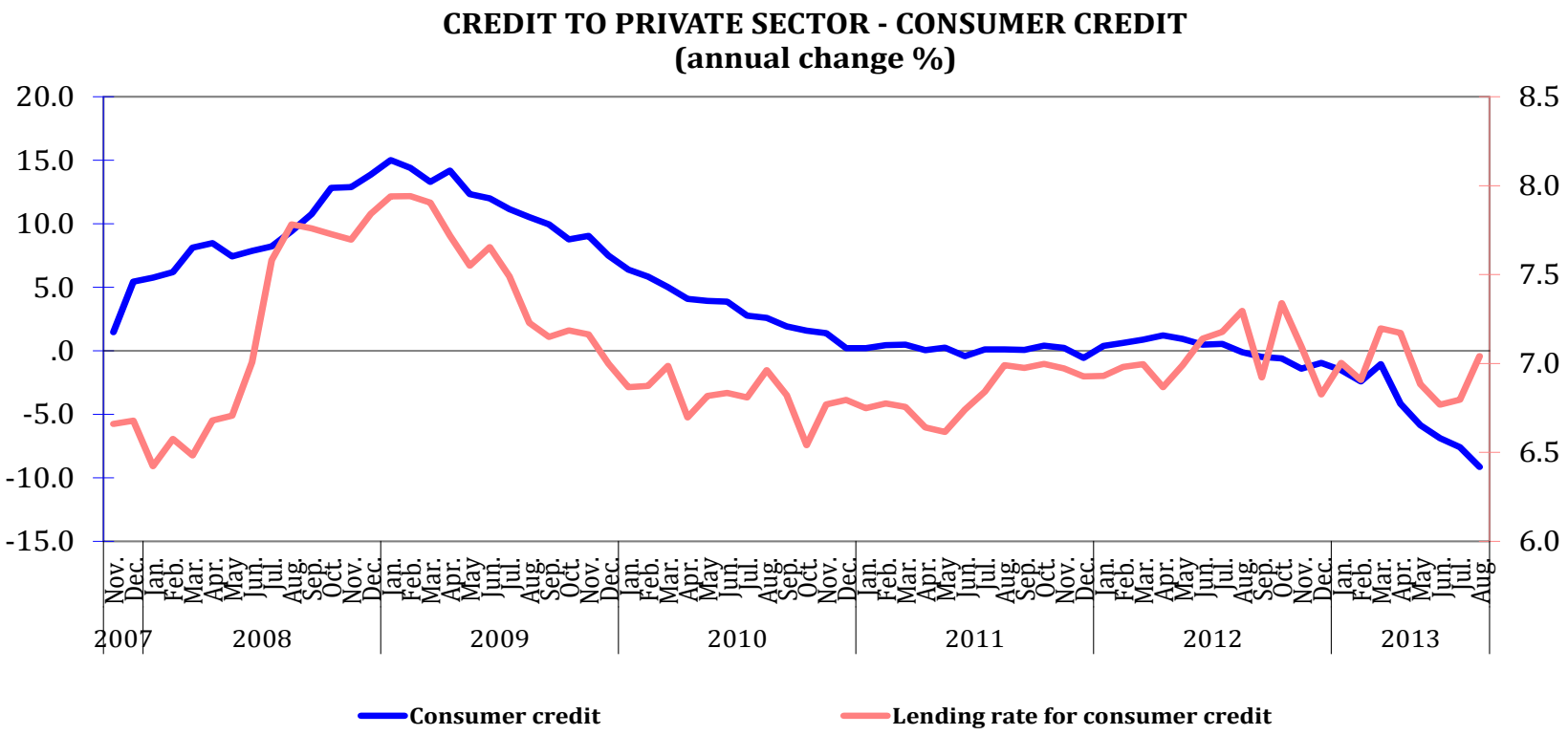



Source: Cystat



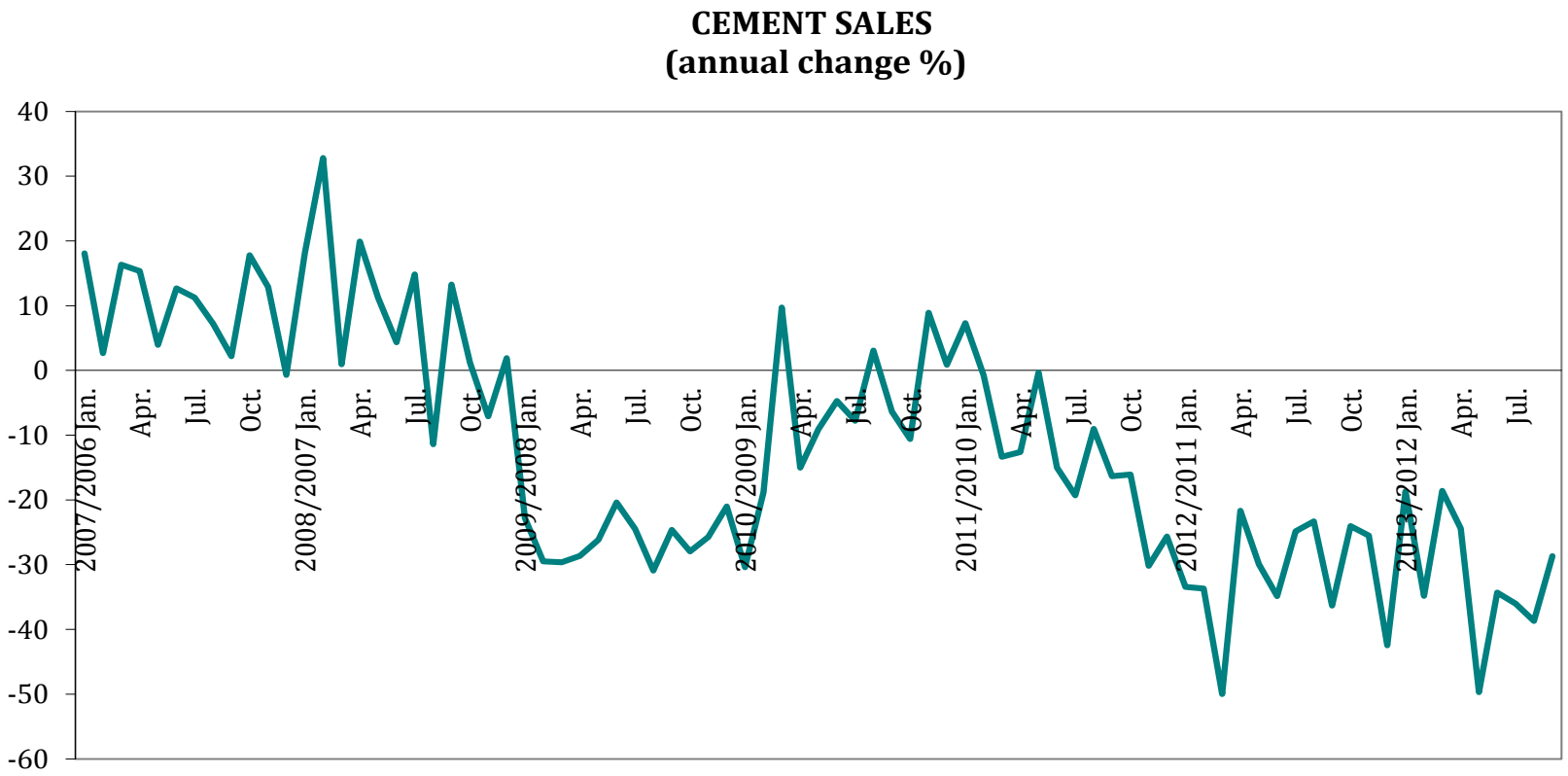

Source: JCC Payment Systems Ltd

Effect during 2013 less pronounced than generally expected.



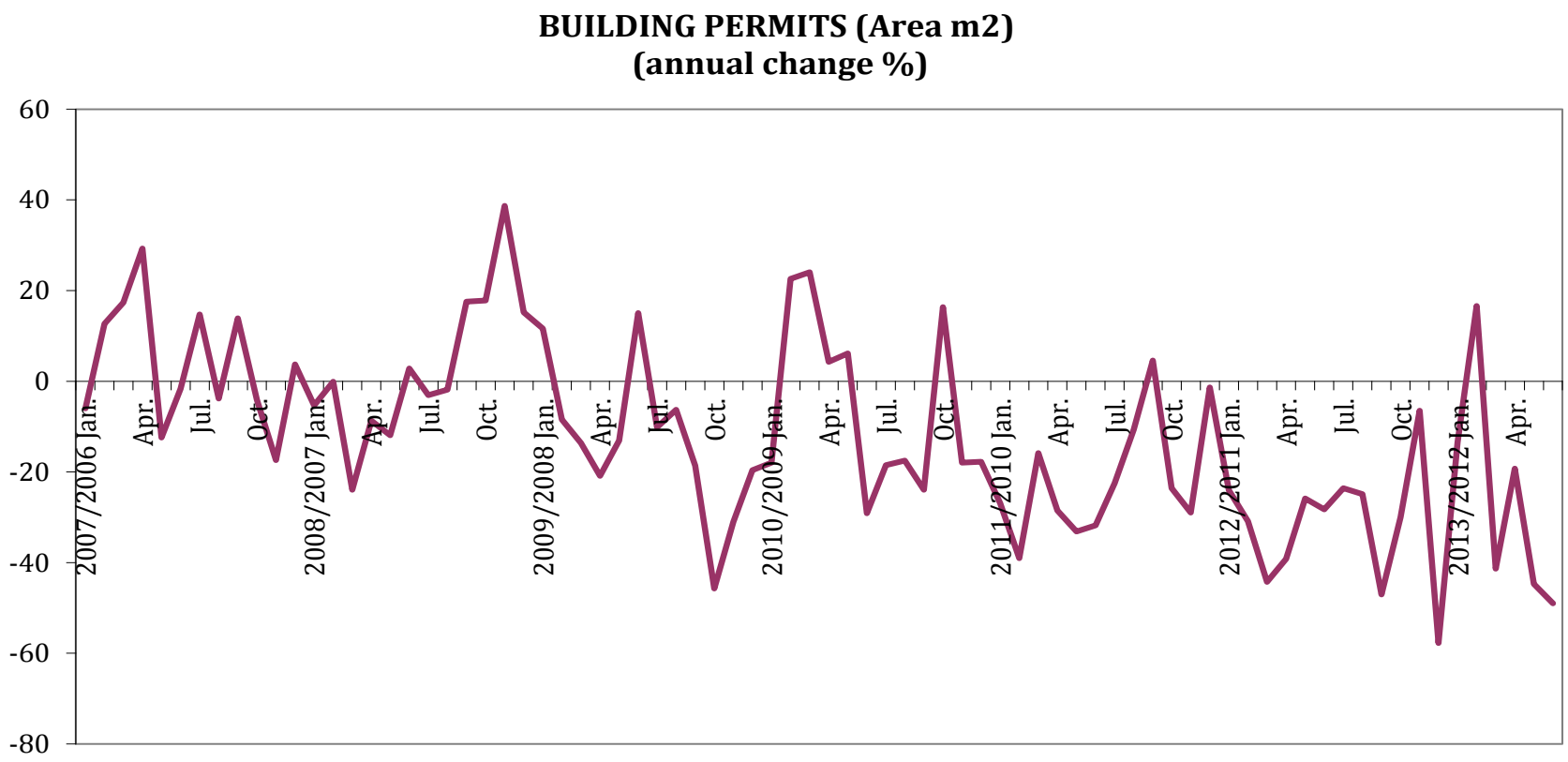

Source: CBC

Credit growth has decelerated, from high levels - lending rates exhibiting a downward trend, following March events.
Interest rates also downward trend. However levels still much higher than the EU on average.



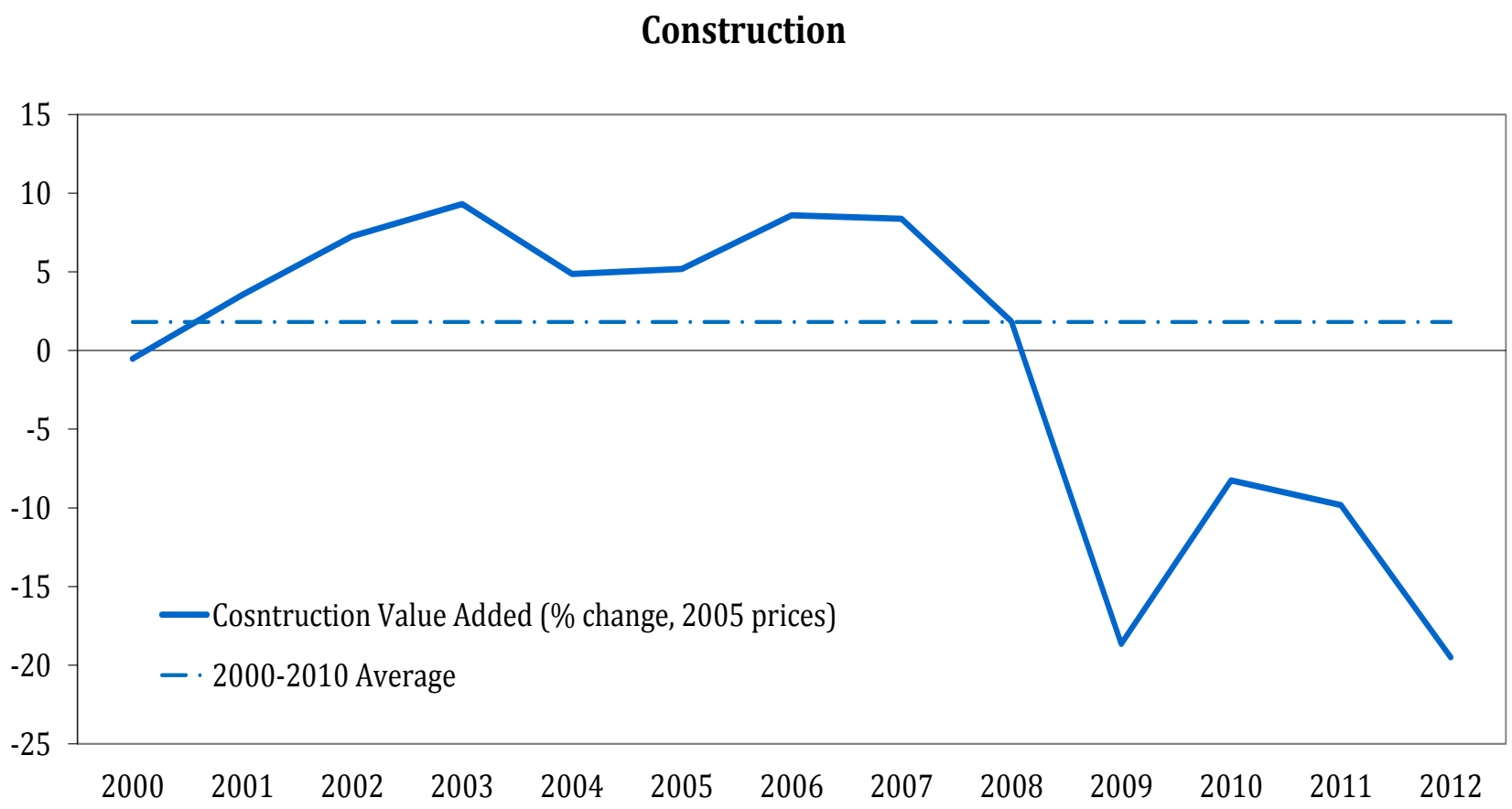

Source: Cystat

Depressed conditions in the construction sector.

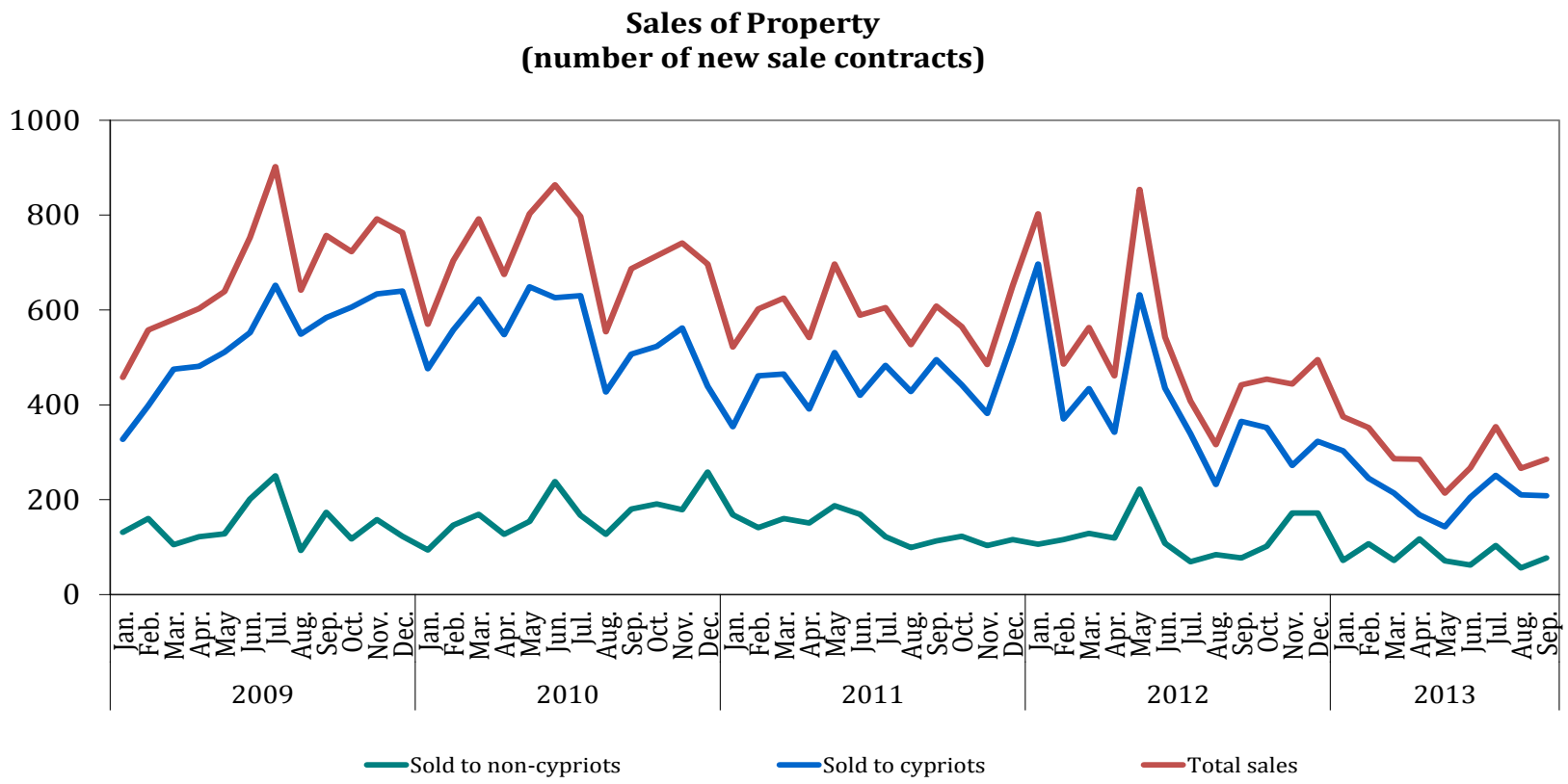



Source: Cystat

Further correction expected in the medium term - housing more affected.

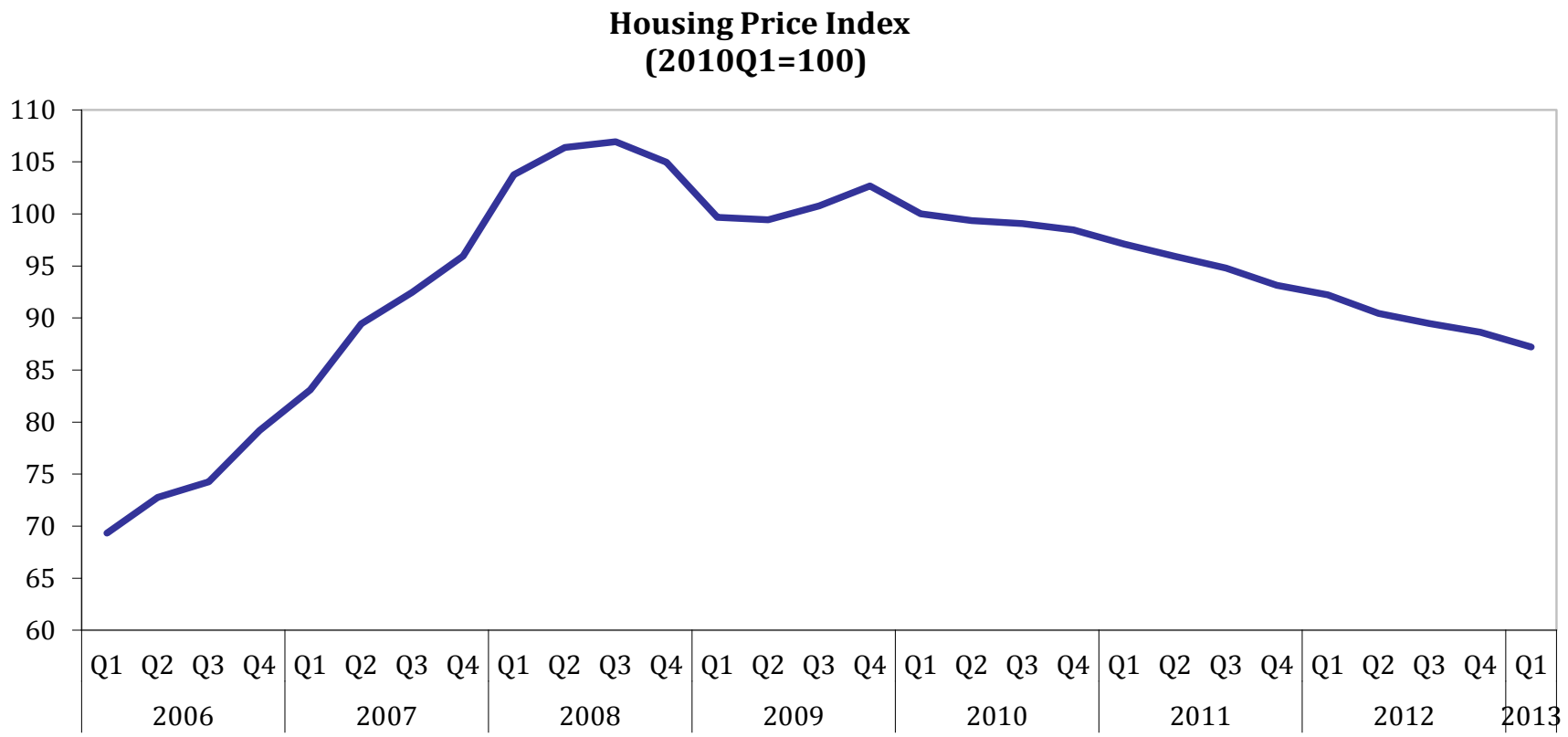



Source: Cystat



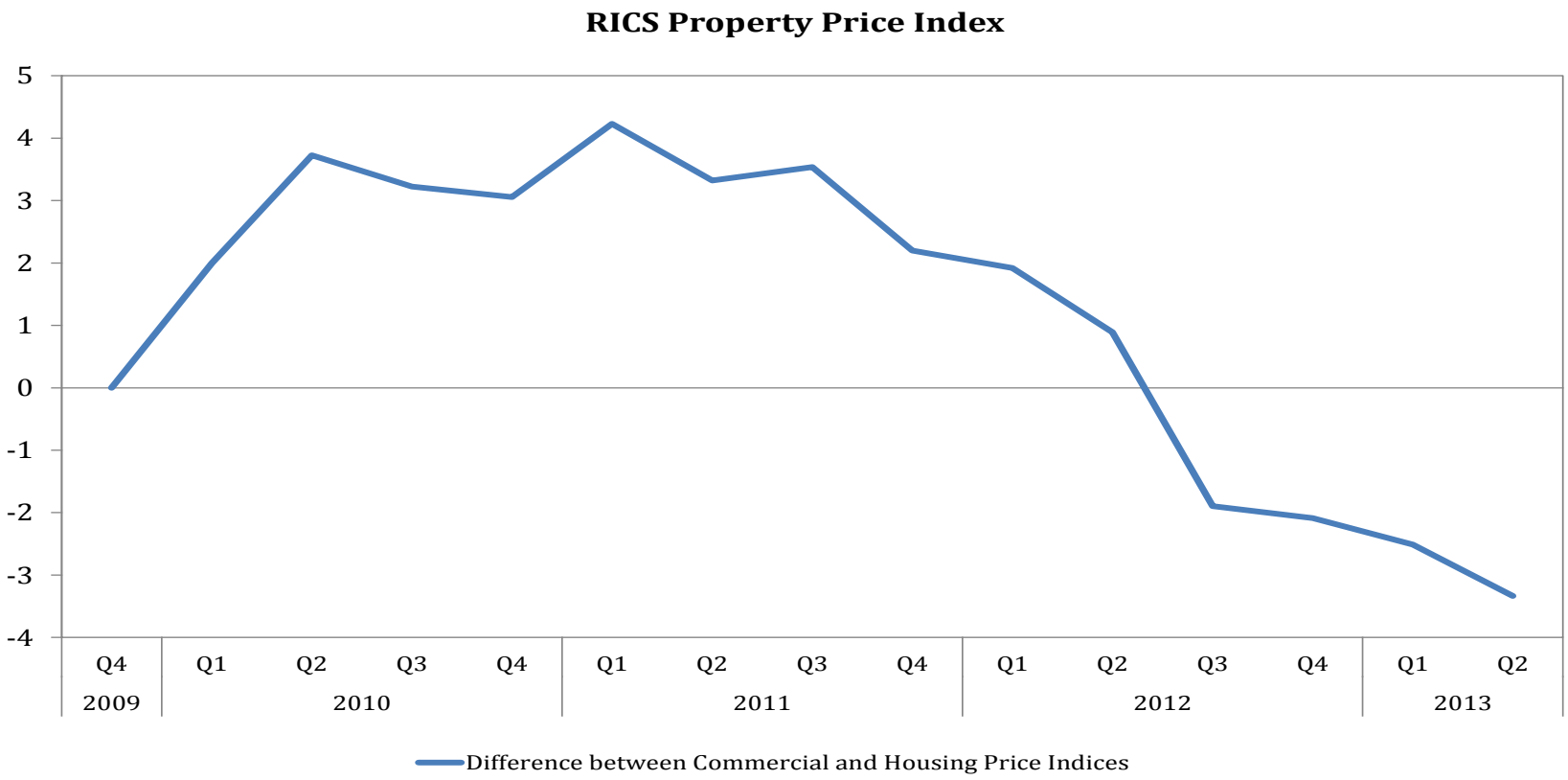

Source: Department of Land and Surveys

Both local and foreign demand suppressed.



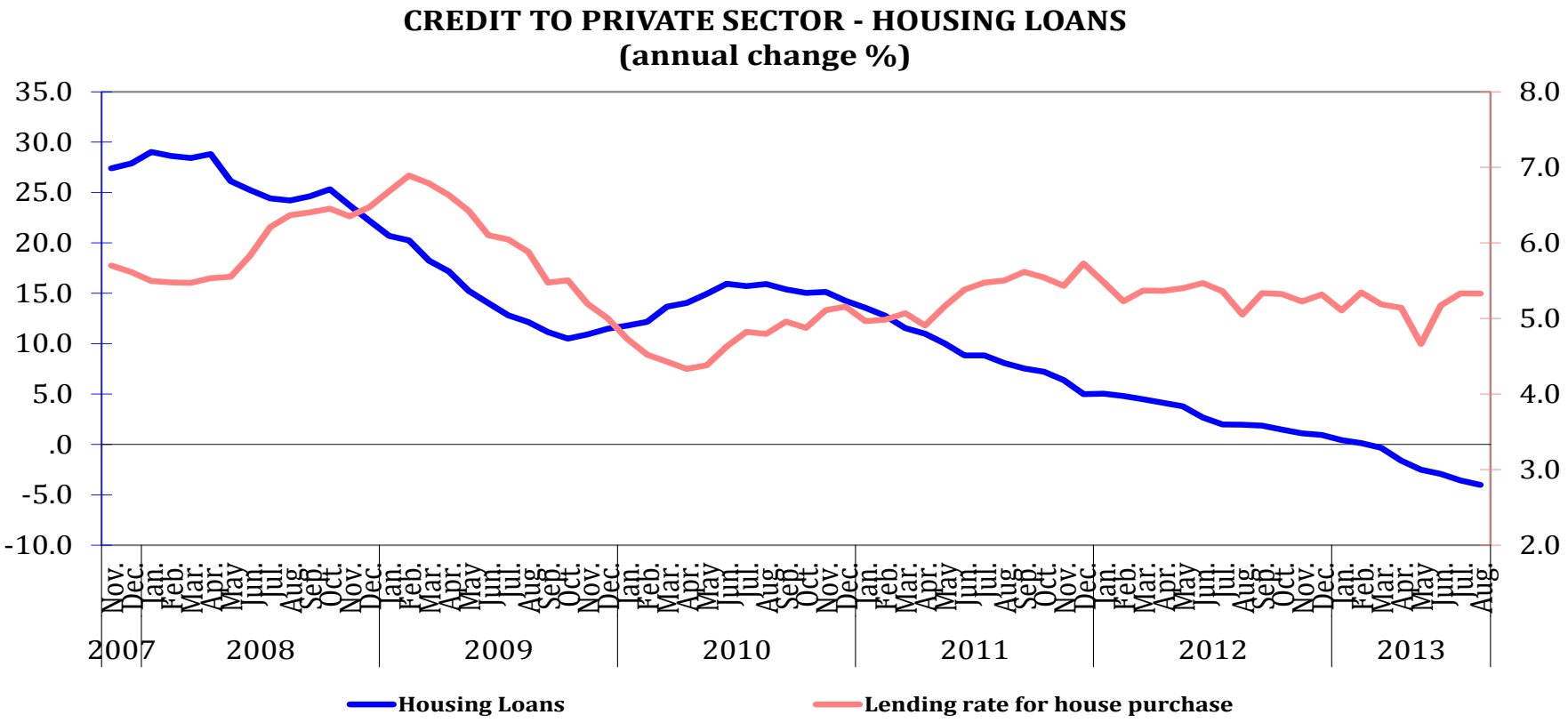

Source: CBC

Prices adjust to demand conditions but in a relatively moderate way.
Total adjustment from peak is –18.4%.



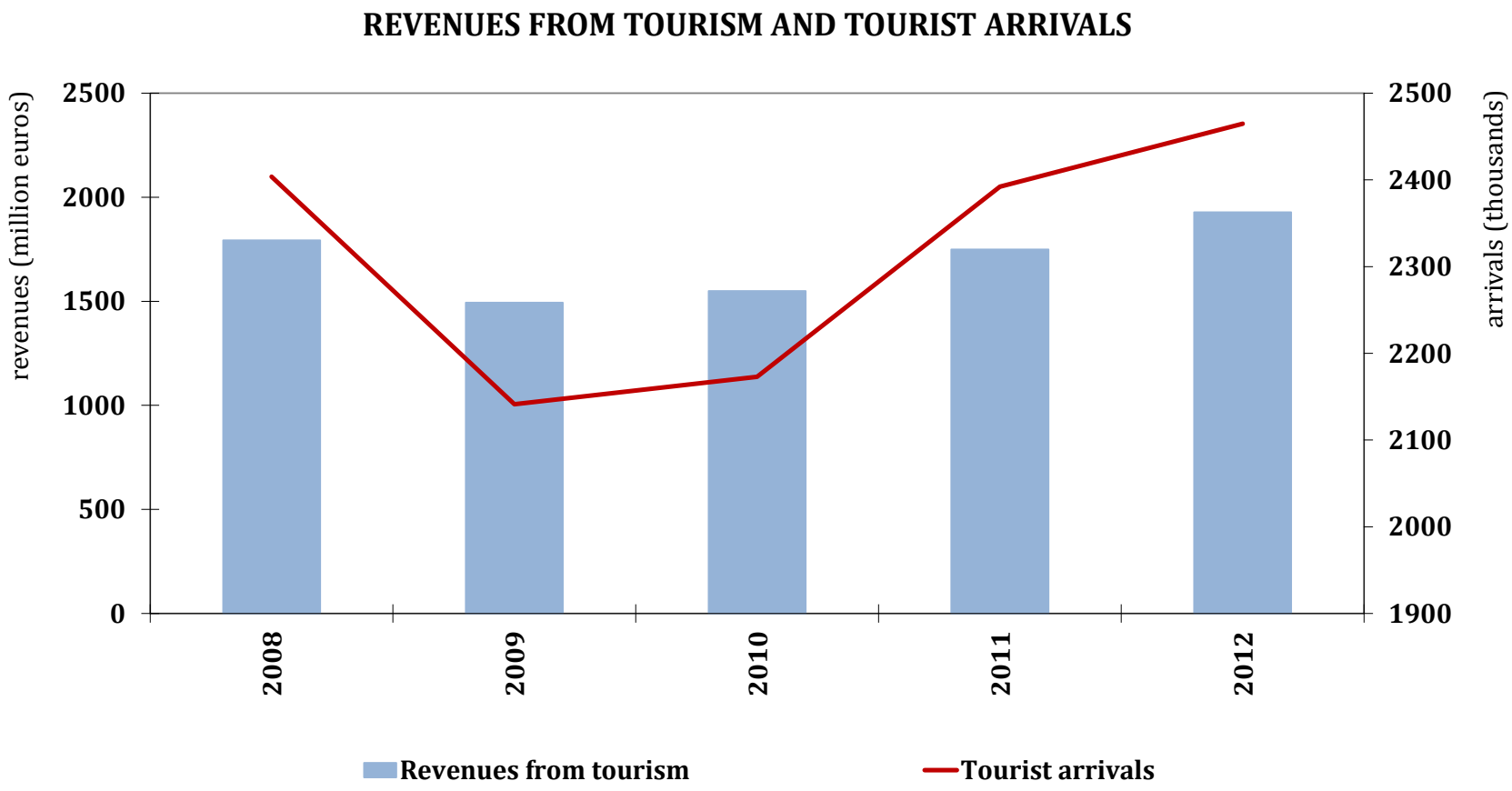

Source: RICS

Effect of crisis on commercial property prices steeper compared to residential prices.




Source: CBC

Substantial cuts in new lending to construction – interest rates remain relatively high.




Source: Cystat

# TOURIST ARRIVALS

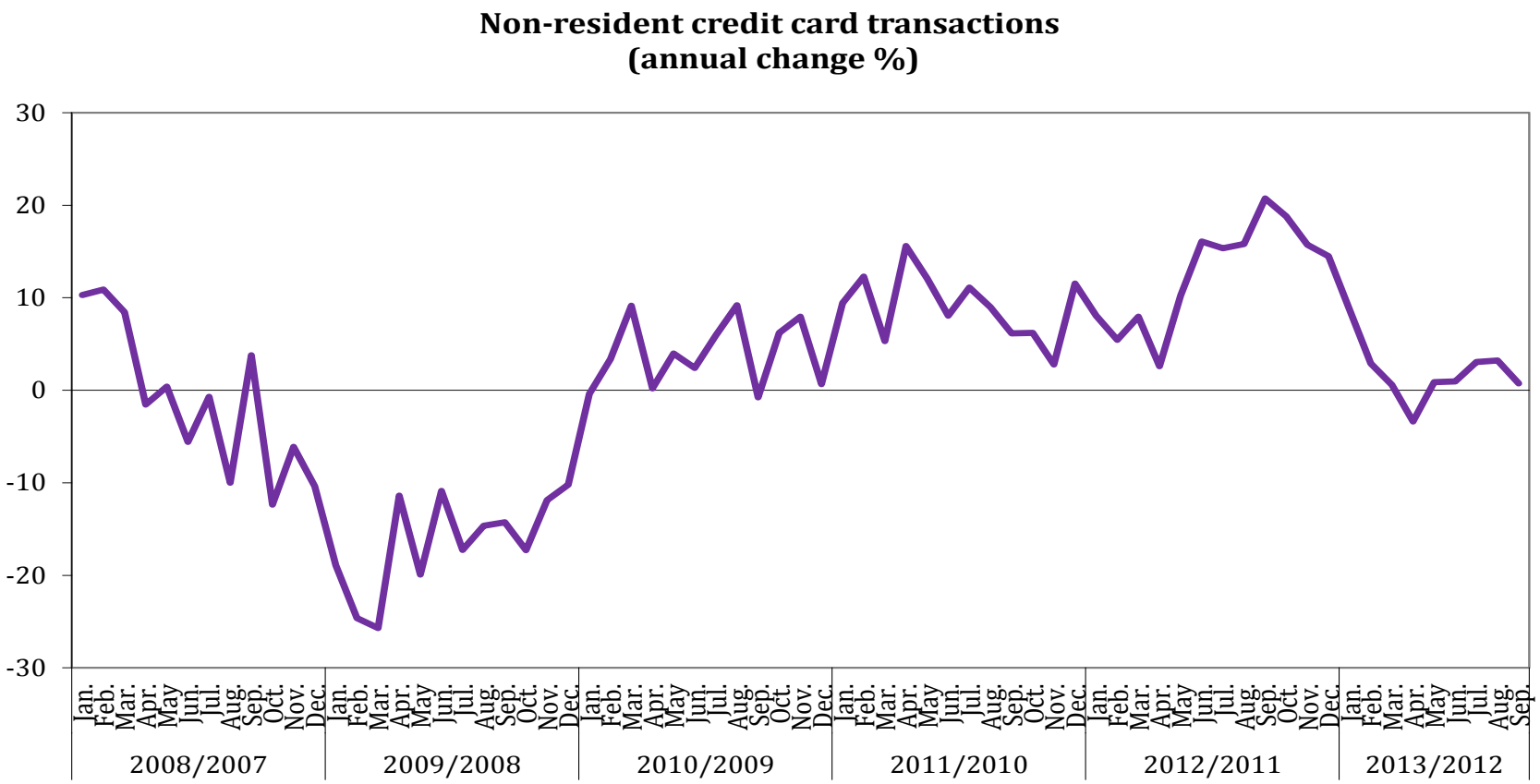
| Tourism | 2009 | 2010 | 2011 | 2012 | 2013/8m |
|---|---|---|---|---|---|
| **Total** | **-10.9** | **+ 1.5** | **+ 10.1** | **+3.0** | **-5.3** |
| United Kingdom | **-14.0** | **-6.8** | **+2.5** | **-6.0** | **-9.8** |
| Greece | **-0.9** | **-3.2** | **+8.7** | **-4.1** | **-23.4** |
| Germany | **-0.7** | **+6.1** | **+13.4** | **-8.5** | **-33.9** |
| Russia | **-17.8** | **+50.5** | **+49.2** | **+42.0** | **+24.0** |

Source: Cystat

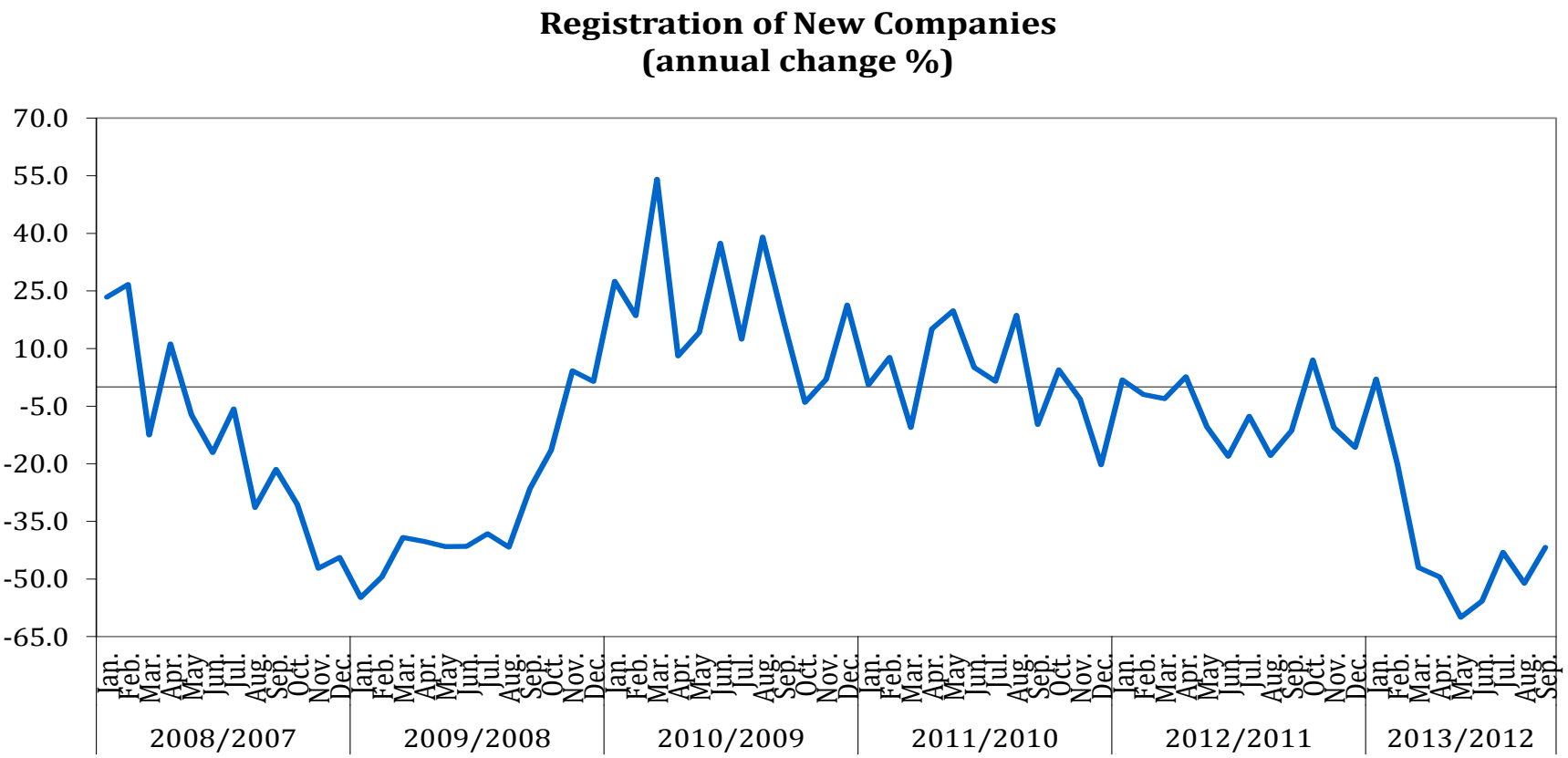
Tourist arrivals by country of origin. Notwithstanding decline in 8m, encouraging signs from some markets (Russia).
According to Cyprus Tourism Organization, a moderate decline is expected for 2013 of around 5%. Revenues expected to remain at last year levels.

# Tourism prospects

- Commitment to “open air” policies opens new opportunities for growth.
- The trends in tourism are towards private arrangements and a bigger role of low cost airlines - Hermes efforts to reach agreement with low cost airlines to increase capacity to Cyprus.
- More room for growth through addressing seasonality.
- Outbound tourism on a declining trend.
- Studies reveal comparative advantages in Cyprus: weather, safety, hospitality. Critical area “value for money”.
- Medium term growth: Arrivals from 1% increase to 3% increase in the medium term and revenues from 3% increase to 5% increase in the medium term.
- Casinos further upside risk (not included in the projections).




Source: JCC Payment Systems Ltd




Source: Department of Registrar of Companies and Official Receiver

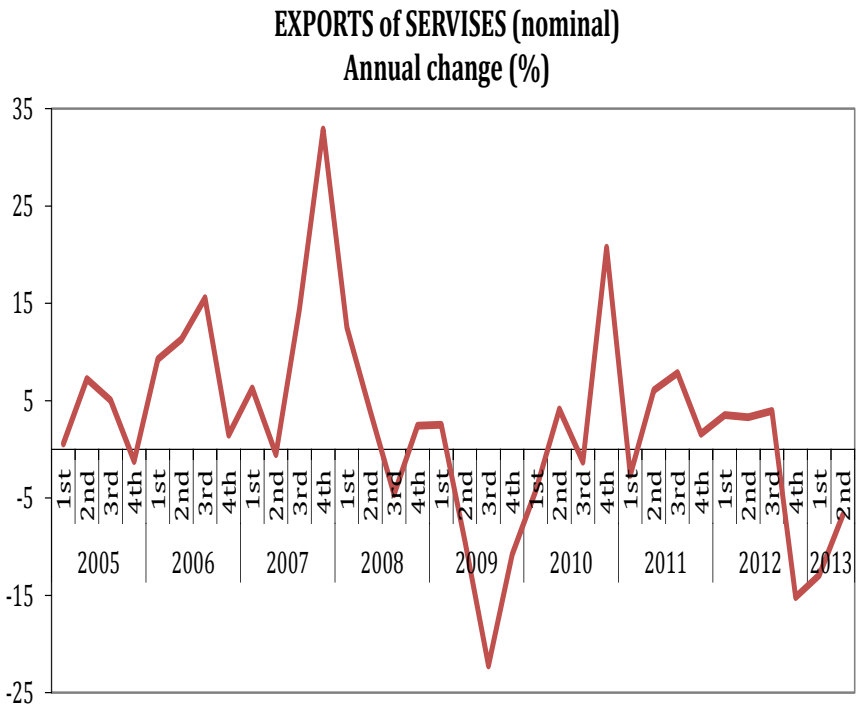
Declining trend – however no evidence of international companies leaving Cyprus, to the extent anticipated.

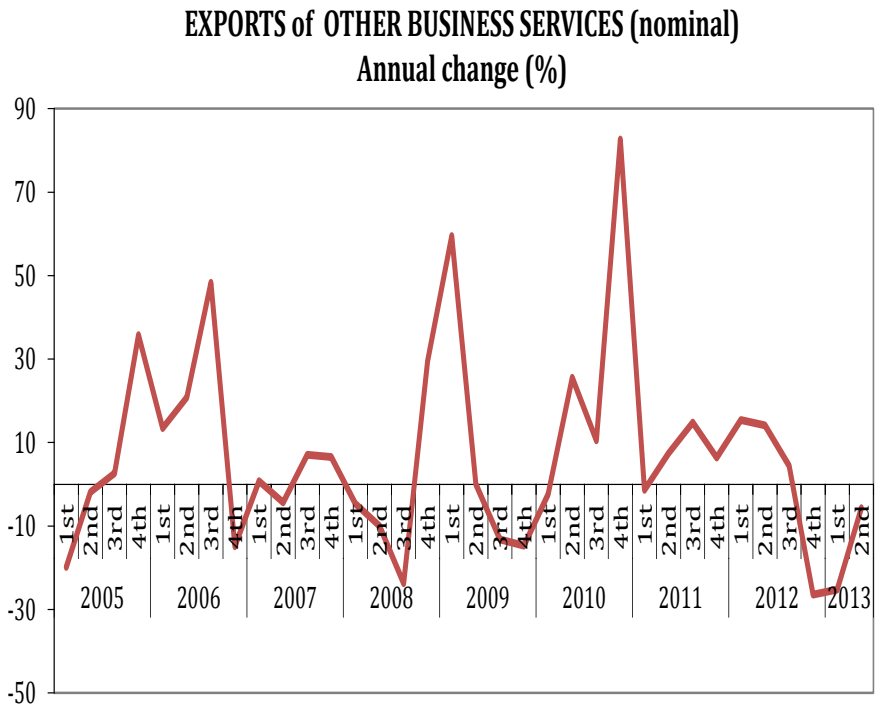
# Services Value Index

| *[2010=100]* | **2011/10** | **2012/11** | **2013/12 6m** |
|---|---|---|---|
| **Information and Communication** | **+0.6** | **-0.9** | **-8.3** |
| -Publishing | -2.5 | -16.4 | -27.4 |
| -Telecommunication | +3.7 | -2.5 | -2.0 |
| -Computers | -3.3 | +22.0 | -7.9 |
| -Information Services | +13.6 | +4.4 | -1.1 |
| **Hotels and Restaurants** | **+5.8** | **+3.0** | **-9.3** |
| **Professional Services** | **+5.2** | **-1.1** | **-9.7** |
| -Architects etc | -2.0 | -20.5 | -28.9 |
| -Legal, accounting, auditing etc | +9.3 | +2.1 | -7.0 |
| **Administrative and Supportive Services** | **-3.7** | **+2.1** | **-11.1** |

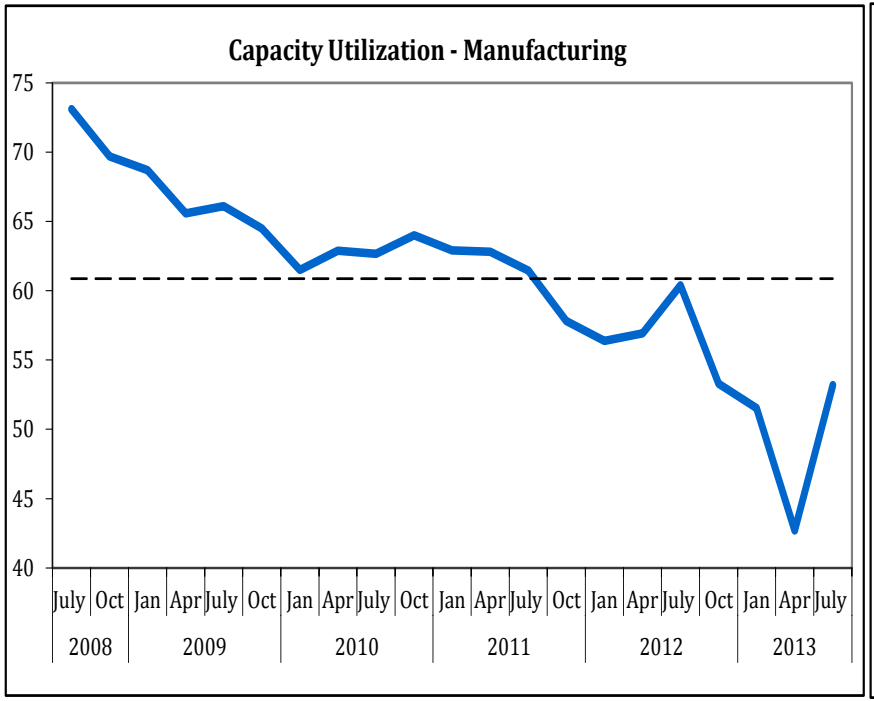
Source: Cystat

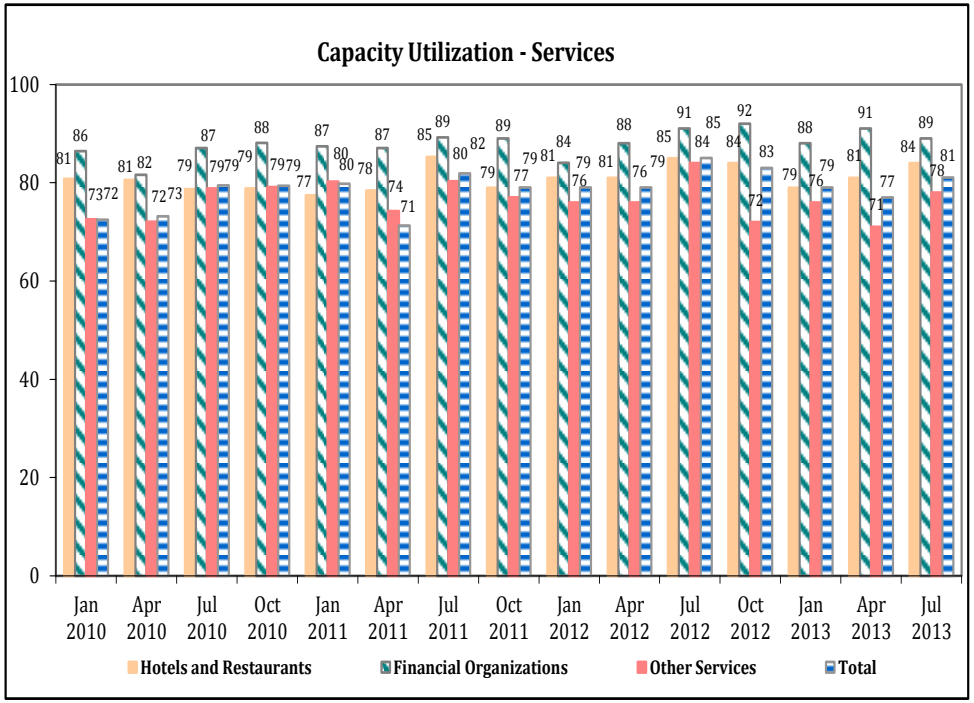
# Exports of services




Source: CBC



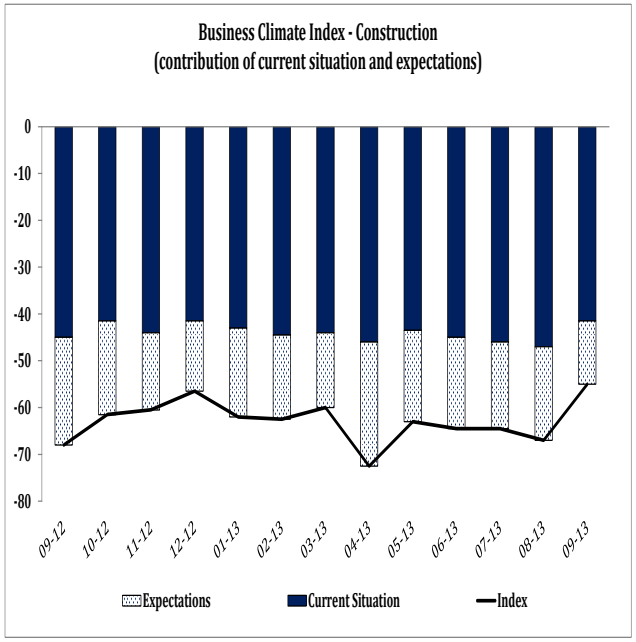



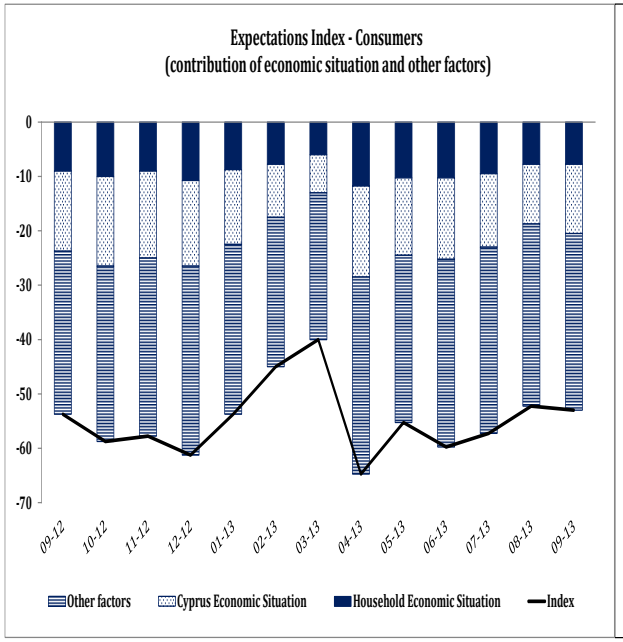

Source: Economics Research Centre

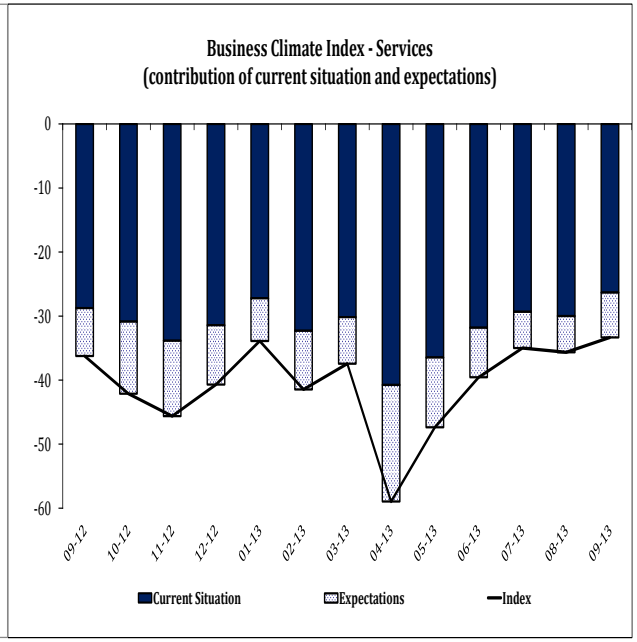
Note: Revised calculation method

Capacity Utilization in Manufacturing & Services – an indication of low pressures on core inflation – weak prospects for private investment looking forward.

# Construction, Consumers and Services sentiment

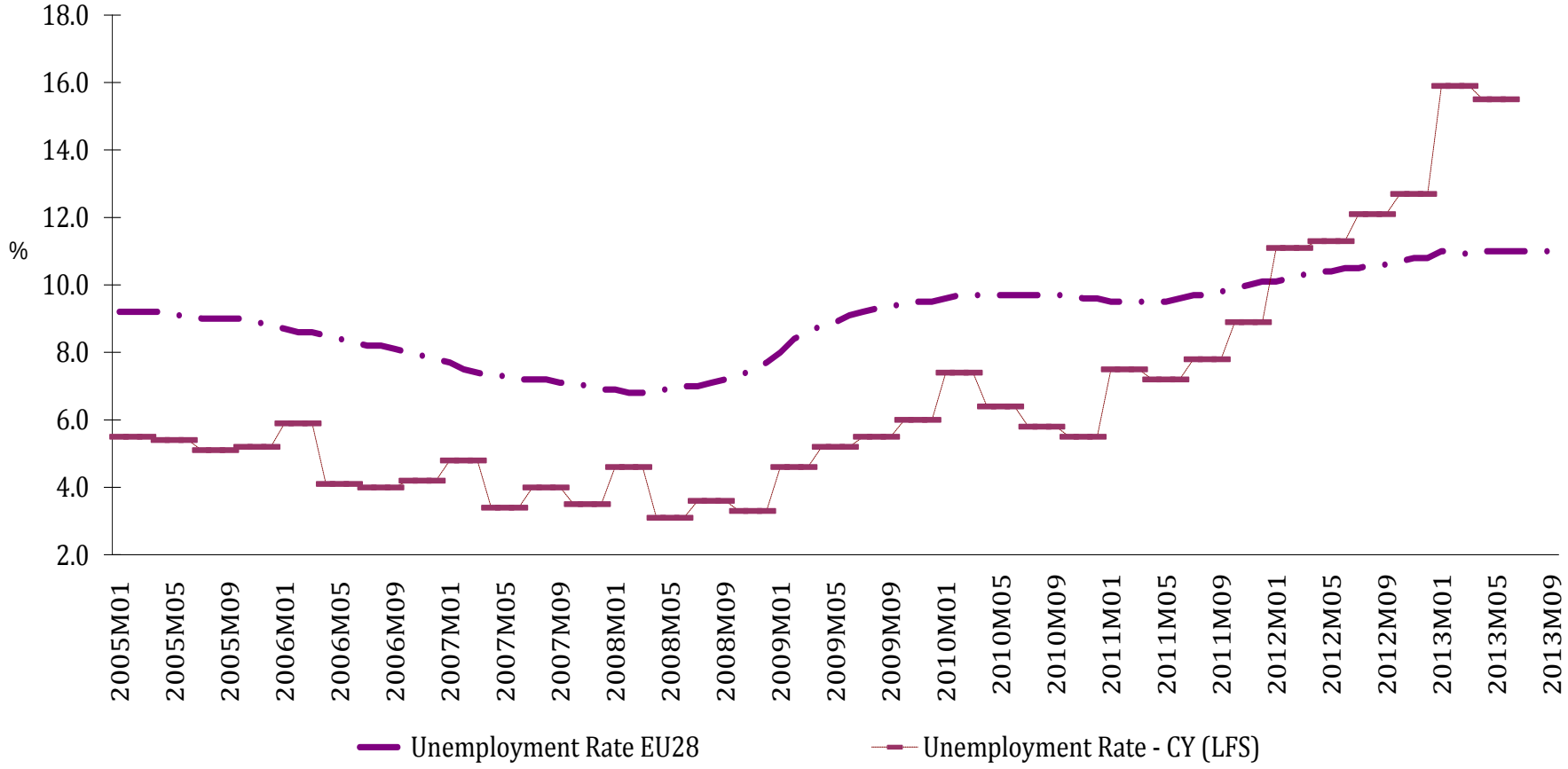


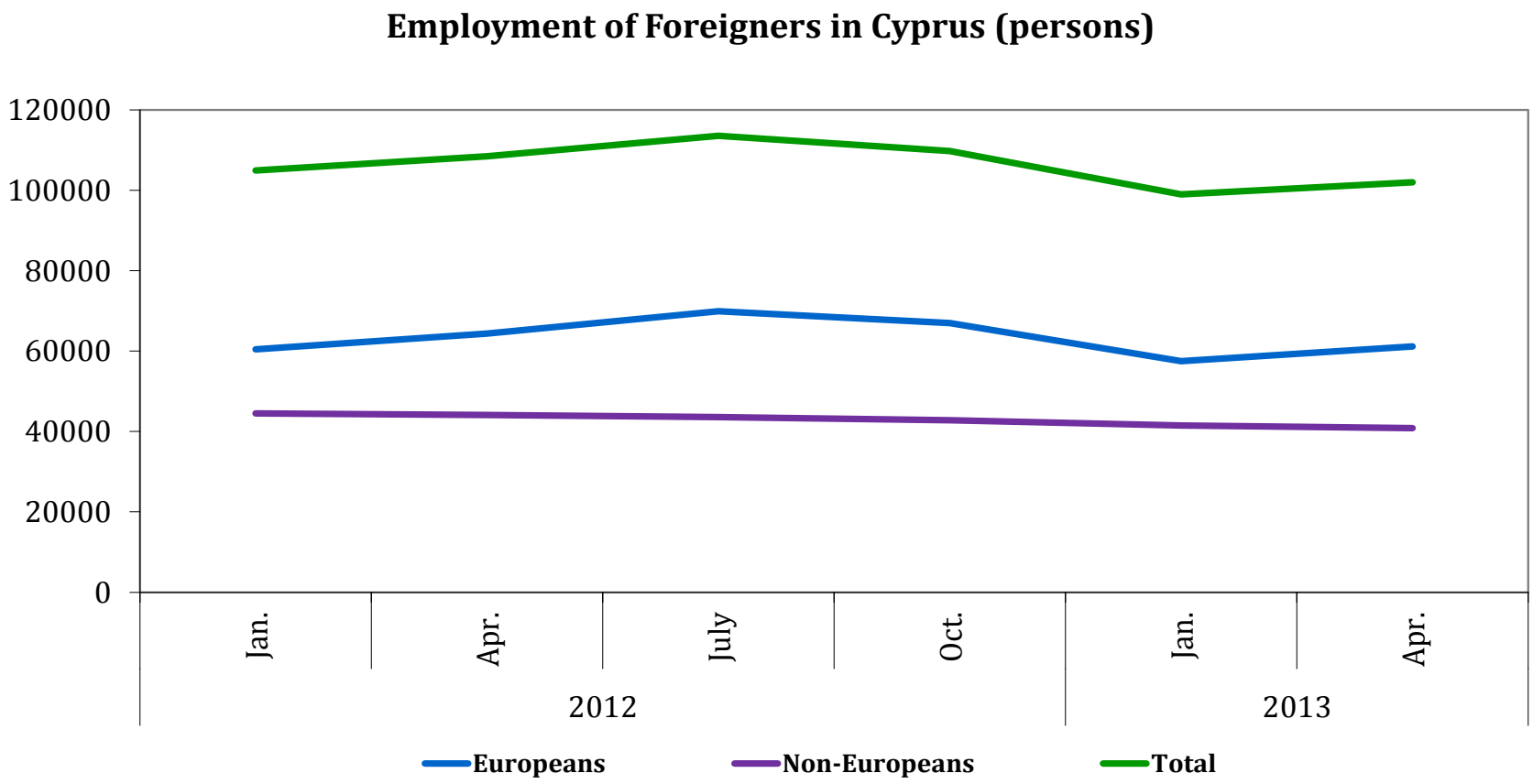




Source: Economics Research Centre

# *Unemployment upward trend*




Source: Cystat and Eurostat

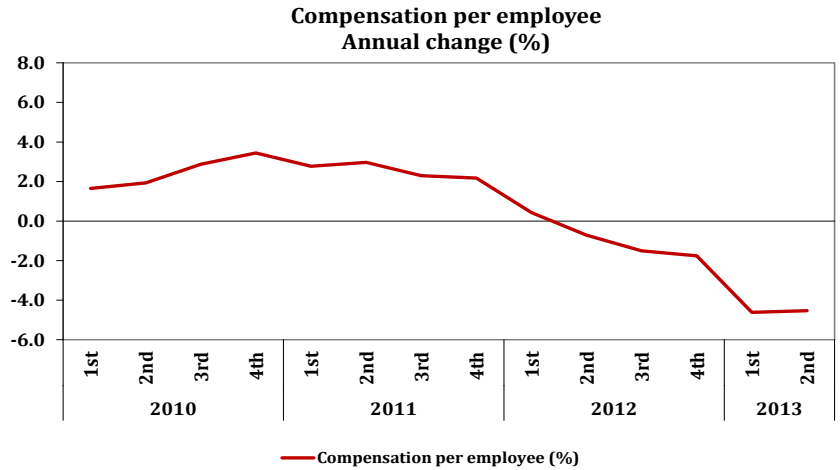


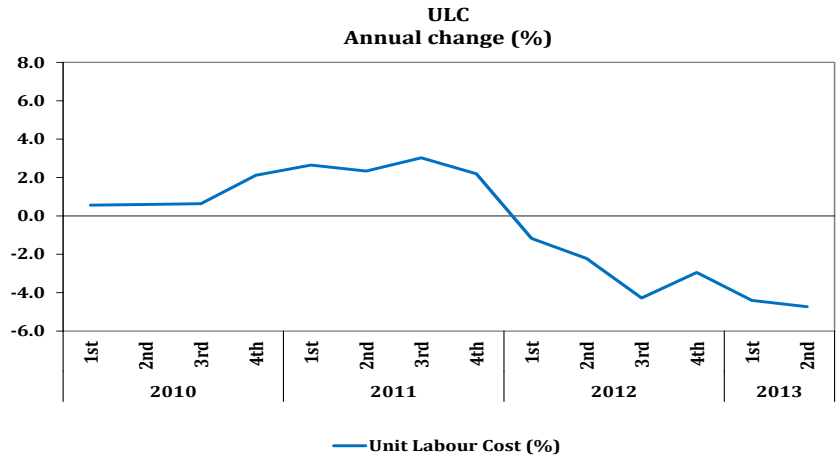

Source: Social Insurance Services

Employment of foreigners  adjust to bleak growth outlook.

Note: The community of insured has been revised based on the Population Registry and therefore the data for 2013 are comparable only with the year 2012 while the year 2012 is not comparable to the previous years.

# Wage Developments




Source: Cystat

- Compensation per employee declined by around 4.6% in 2013/6m.
- Sectoral variations
- Wage moderation after 2010
  - Public sector wage cuts 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

# Sectoral Collective Agreements

- In 4 sectors (banking, tourism, constructions and public sector) wage collective bargaining agreements renewed for 2013-2015, with much lower labour pay.
- The above collective sectoral agreements cover around 32% of the total labour force.
- It is worthwhile denoting that all above sectors are strictly unionized…
- The average wage cuts are for the banking sector around 20%, in the tourist and the public sector 14% and in construction 12%.
- The downward trend adjustment of wages is expected to gradually improve employment opportunities.

# 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 minimum 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 |
| 2012 | 924 | 1.7 | 1614(prov) | -11.3 | 57.2 |

# Memorandum of Understanding («MoU»)

# MoU

- After intensive discussions, agreement on 25th of March 2013 at Eurogroup level
- 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

# First Quarterly Review

- Outcome of 1st quarterly review (published by European Commission) – economic adjustment programme is on track, noting in particular:

  - Fiscal developments: Cyprus fully achieved targets of MoU

  - Financial sector: supervision, recapitalization, restructuring – implementation in line with targets

  - Structural measures: implementation as scheduled
- Delays in implementation: not expected to affect economic outlook – new dates set in revised MoU – Cyprus committed on meeting targets
- Downside risks relate in particular with the uncertainty surrounding economic outlook in Cyprus and abroad

# Development in specific measures

- Measure 3.3: Partially compliant at 1st review – new deadline Q4:2013 – substantial progress achieved – work proceeds as scheduled
- Measure 3.5: Partially compliant at 1st review – Report on inventory calculations by Treasury delivered on time
- Measure 5.4: the only non-compliance at 1st review – since then, relevant legislation approved by House of Parliament on 5th September 2013

# MoU - Structural Measures

- Important Structural Measures included in MoU· to address a number of structural weaknesses - contribute to economic growth

**<u>Structural Measures cover the areas of:</u>**

- Enhancement of Budgetary Framework
- Labour market reform
- Pension reforms
- 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 – change of working times, reduce impediments to staff mobility. Independent external review for further reforms.

# MoU - Structural Measures (cont'd)

- Improvement of the regulatory framework for the creation of Public-Private partnerships.
- Privatizations of state-owned enterprises and semi-governmental organizations, to improve economic efficiency through enhanced competition.
- Immovable property tax reform.
- 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

- COLA will not paid to employees before 2016
- Recently adopted a reform of the cost of living adjustment public wage indexation system (COLA): partial (rather than full) indexation of public wages and automatic suspension during recessions

# Labour Market structural reforms

- Maintaining minimum wage at its current level. Any change in the **minimum wage** should be in line with economic and labour market developments.
- Planned reform (Q2-2013) of **public assistance** to reduce disincentives to work and imposing job search requirements for continued benefit receipt.
- Review and enhance cooperation between PES and the benefit-paying institutions in the activation of the unemployed.

# Pension Reform

- Ambitious pension reforms, improvement of long-term viability of the pension system.
- Actuarial study to assess the effect of the recent pension reforms on the financial viability of the general pension system.
- The actual reserve and the expected revenue of the SIF are sufficient to cover expected costs until 2060.
- The pension reform adopted in December 2012 will reduce the pension expenditures of the Social Insurance Fund as a percent of GDP by about 6 percentage points in 2060, reducing to approximately 10% of GDP.

# MTBF

- An MTBF law compliant with EU requirements approved in December 2012.
- Agreement to finalize secondary legislation and regulations to have the MTBF in place for the 2014 budget, and 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 2016.
- Core inflation stable around 1½-2%, headline rate dominated by oil effects, food prices and taxation.
- Current account deficit: expected gradual improvement due 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 | -7.0 | -4.5 | +0.5 | +1.0 |
| Unemployment (%) | 11.8 | 16.5 | 20.0 | 20.0 | 19.0 |
| HICP Inflation (%) | 3.1 | 1.0 | 1.3 | 1.6 | 1.7 |

# Projections for real GDP growth

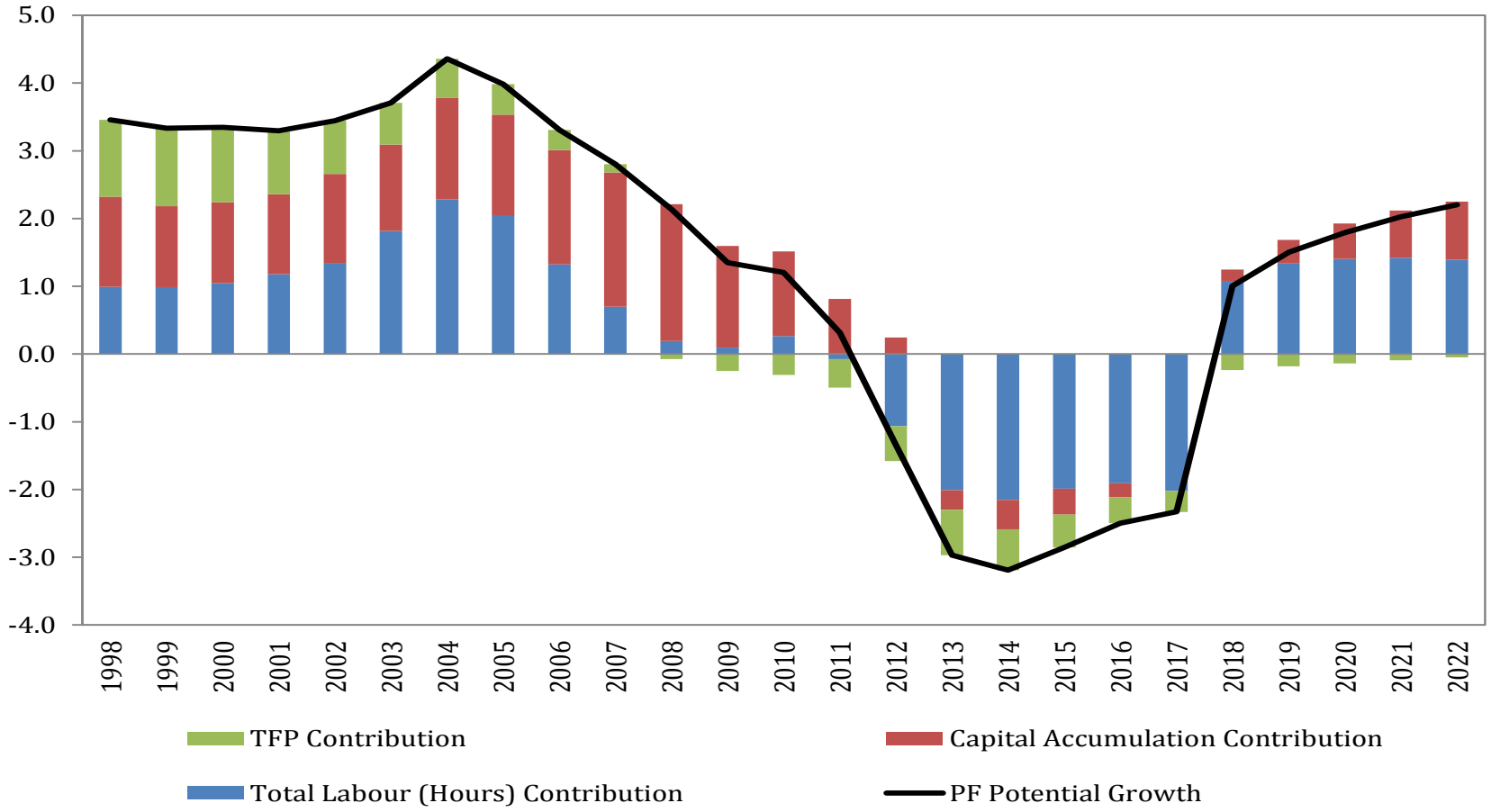
| % | Ministry of Finance | *Carry-over effect* | Troika[1] | CypERC[2] | Spanos & Papadopoulou[3] |
|---|---|---|---|---|---|
| **2013** | -7.0 | *-6.1* | -8.7 | -5.7 | -5.0 |
| **2014** | -4.5 | *-4.8* | -3.9 | -4.9 | -5.6 |
| **2015** | 0.5 | … | 1.1 | … | -4.1 |
| **2016** | 1.0 | … | 1.9 | … | -1.5 |

[1] *Troika- Macro Framework Rev1*

[2] *CypERC – July 2013 - Mean Forecast*

[3] *Spanos and Papadopoulou (CBC, 2013-02) – Scenario 1*

# Potential GDP



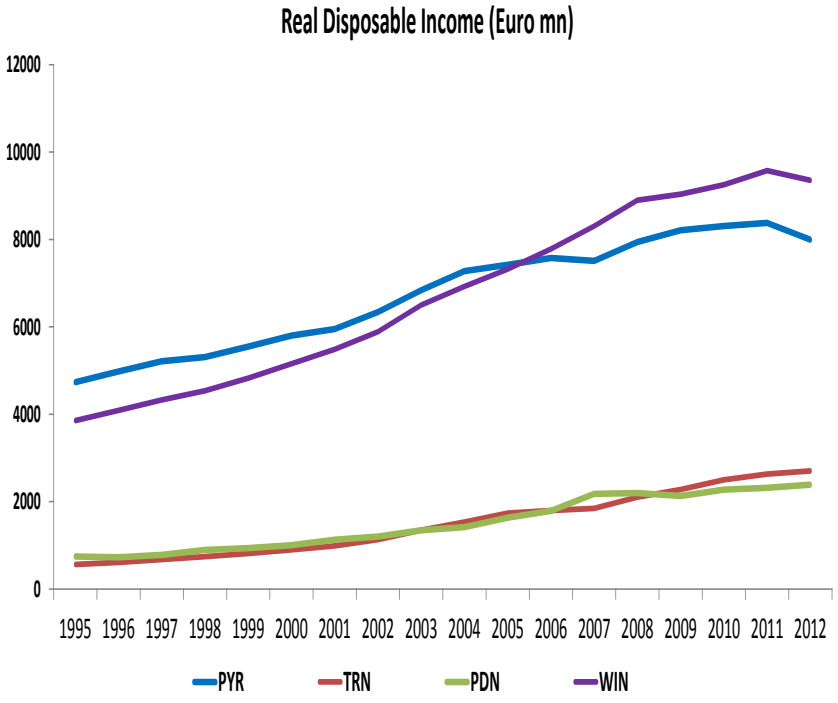

Source: Output Gap Working Group

# Private Consumption

- Private consumption is affected by Disposable Income (DI), price developments, savings decisions and wealth effects.
- Disposable Income is affected by:
  - Employment & wages
  - Fiscal stance, credit
  - Other income, including income from interests - therefore, deposits haircut affects spending through loss of interest income
  - Deposits haircut affects spending also through wealth effect
  - Savings are affected by confidence and wealth effects

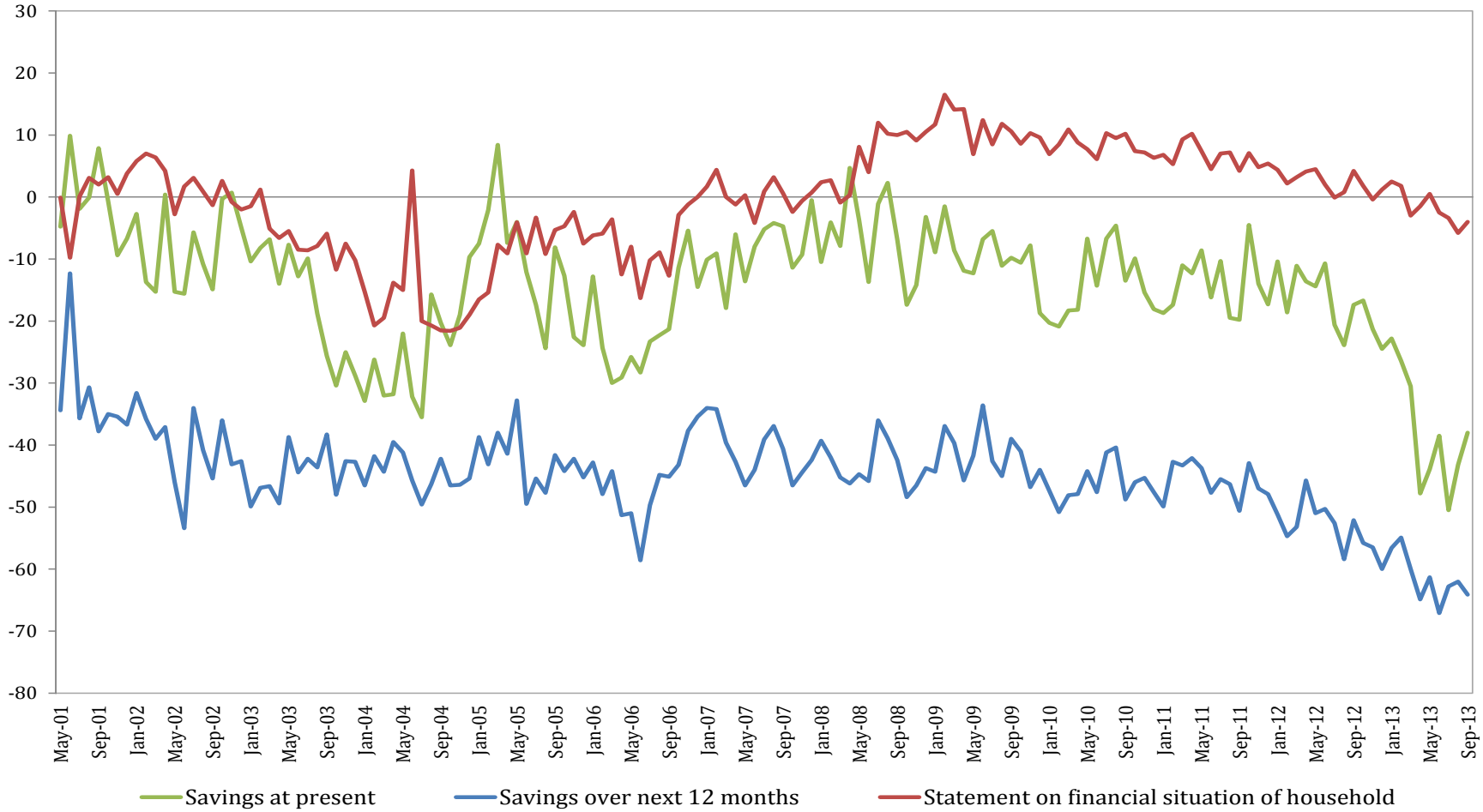
# Disposable Income

- Real private sector disposable income = PYR
- PYR=(WIN+TRN-PDN)/PCD
  - WIN = Nominal Wages
  - TRN = Transfers from governments to households
  - PDN = Household income tax and social security contributions
  - PCD =Private consumption deflator




Source: Spanos and Papadopoulou (CBC, 2013-02)

# Savings

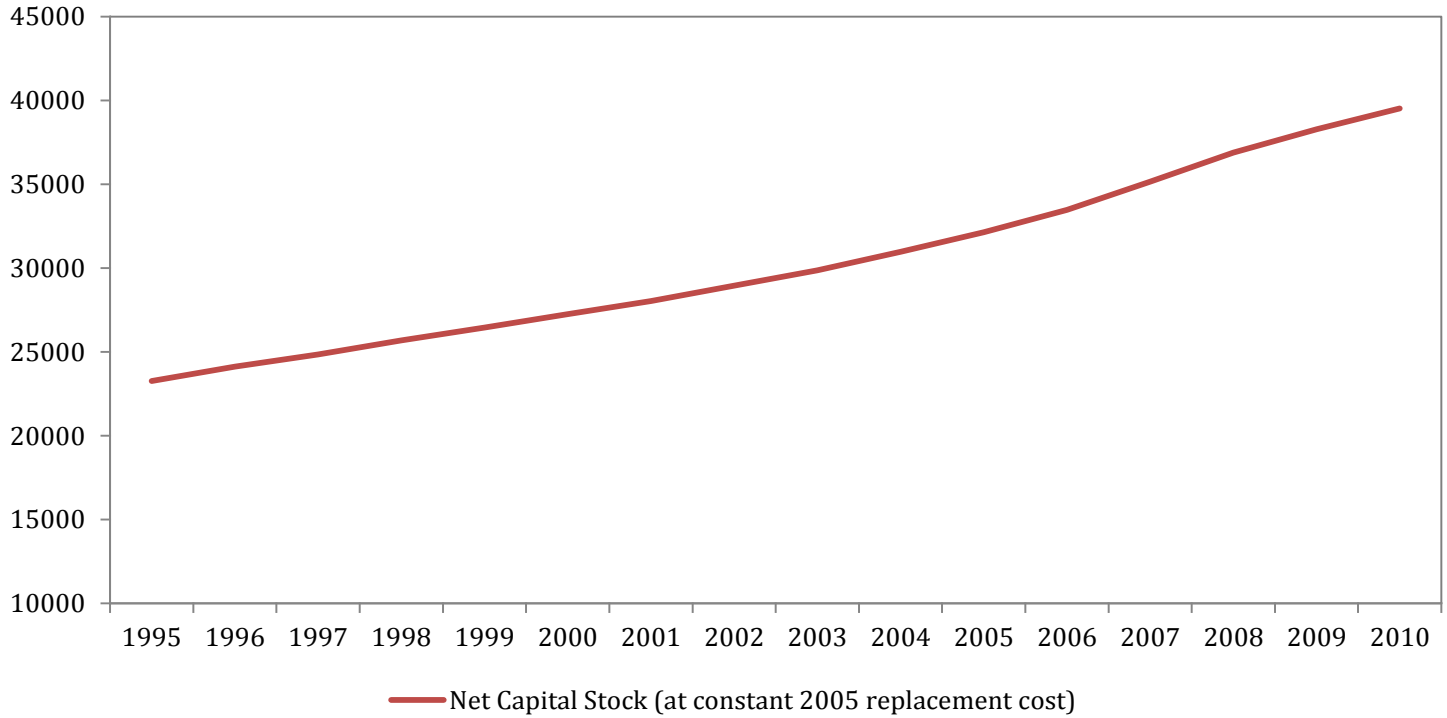



Source: CypERC, Business and Consumer Surveys

# Investment

- GFCF breaks in:
  - Government
  - Semi-Government (EAC, CYTA, CPA)
  - Private sector (VTTI, Noble) - Imports represent the biggest part of investments therefore in 2015 increase in investment will be accompanied by a is a significant increase in imports of intermediate inputs and capital goods, mainly due to VTTI and Noble.

# Capital Stock




Source: Cystat

Effect on potential GDP growth.

# 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.

- **<u>Reasons for resilience:</u>**
  - 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)

- **Tourism -** Evidence that dynamism in tourist arrivals will continue in 2013 – efforts to improve cost competitiveness will contribute positively

# 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

- Recapitalization of banks – restoration of lending to the economy.
- Adjustments of wages and prices.
- Pensions: Reductions - new actuarial report.
- Public sector reforms – organizational streamlining / MTBF.
- 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.
- Privatizations, PPP.

# Capital Controls in Cyprus

- Impact of capital controls on economy:
  - Funding costs increase – transactions mostly on a cash basis
  - Disruption of the normal functioning of the economy, especially for businesses
  - Act as deterrent for inward foreign investment
- However, significant relaxation of controls, normality is slowly coming back
- Road map agreed with Troika for further actions – use of milestones instead of time bound map (recapitalization of Cooperatives, progress in the implementation of the restructuring plan for Bank of Cyprus etc.)

# Conclusions

- Uncertainty reinforced by events
- Low growth environment
- Investment in infrastructure (related to natural gas), lower energy prices, 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