Cyprus

The worst is over

The adjustment programme set up in 2013 has ended on a positive note. Growth has returned and employment is picking up. Public finances have undergone in-depth reforms, paving the way for gradual debt reduction in the medium term. The banking sector's shock treatment was a success: the Cypriot experience of resolving banking crises became a reference for the EU. Although the worst of the banking crisis is over, several years of convalescence will still be needed. Non-performing loans, especially mortgages, are still a big problem, and resolving it might require further government efforts.

Cyprus completes its structural adjustment programme

In mid-March 2016, two months before the official expiration date, the Cyprus government announced that it had completed its adjustment programme with the IMF. Under the triannual programme launched by the Troika (the European Union, the European Central Bank and the International Monetary Fund) in April 2013, this small country in the throes of a severe banking crisis was offered financial assistance totalling EUR 10 bn (55% of the country's annual GDP) in exchange for a structural adjustment programme, including notably restructuring of the banking sector.

The programme ended on a positive note. Cyprus returned to growth in 2015 after three years of recession during which GDP contracted 11%. The recovery has been mild (+1.6% in 2015), but is nonetheless stronger than expected, surpassing the forecasts of the IMF and the European Commission. Growth accelerated during the second half of the year, buoyed notably by a rebound in tourist flows to the island: tourism revenues increased 4.4% in 2015, offsetting the 2.8% decline in 2014.

The unemployment rate has fallen from a peak of 16.5% at the end of 2014. Adjusted for seasonal fluctuations, it reached 13% of the active population in November 2015. The job market recovery should help shore up household solvency, which in turn should improve the prospects of ending the systemic banking crisis (see below).

Inflation is mired in negative territory for the third consecutive year. Average inflation was -1.5% in 2015 (vs. -0.3% in 2014) and deflationary trends have extended into early 2016 (-1.65% year-on-year in the first 2 months). Cyprus – a small, open Eurozone economy – does not have the means to withstand the region's deflationary pressures. Persistent deflation also reflects the fragility of Cyprus's current recovery: in nominal terms, GDP growth only barely levelled off in 2015.

Fiscal adjustment

Over the past three years, the country's fiscal performance has been stronger than expected. After reaching a record high of 9% of GDP in 2014, the budget deficit has narrowed spectacularly to an estimated 1.3% in 2015 (based on European Commission methodology). On a cash basis, the government ended the year with a primary surplus of 1.8% of GDP. Rebalancing public finances required tax increases and spending limitations, notably a freeze on public sector wages. The corporate tax rate was increased to 12.5% and the VAT – to 19%. The tax administration was overhauled as part of far-reaching reforms. Major state-owned companies were privatised, including CYTA, the national telecom operator, and the Limassol Port Authority.

1- Summary of forecasts

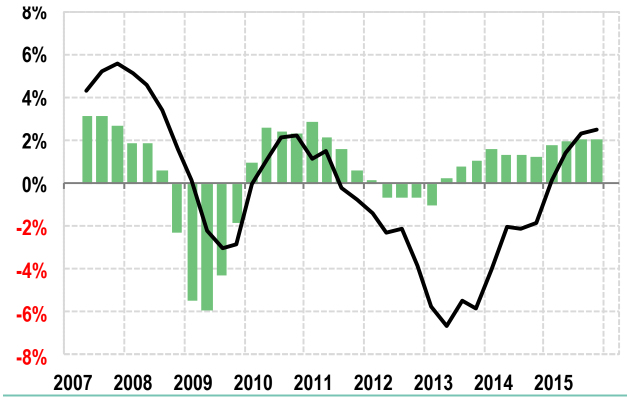
	2014	2015	2016f	2017f
Real GDP growth (%)	-2.3	1.6	1.5	2.0
Inflation (CPI, year average, %)	-0.3	-1.5	-1.0	0.6
Government balance / GDP (%)	-8.9	-1.3	0.1	0.9
Public debt / GDP (%)	108.2	108.4	99.9	95.0
Current account balance / GDP (%)	-4.5	-4.7	-4.2	-3.9
External debt / GDP (%)	439.1	561.6	566.9	560.7
Forex reserves (USD bn, gross)	974	822	899	950
Forex reserves, in months of imports	0,9	0,8	0,9	0,9
Exchange rate EUR/USD (year end)	1.21	1.09	1.14	1.05

f: BNP Paribas Group Economic Research estimates and forecasts

2- Renewed growth

GDP growth, %

EU-28, ----- Cyprus



Source: EU Commission

Yet completion of the adjustment programme does not mean the end of austerity. The bank bailout was extremely costly for the government. Public debt has soared, from 45% of GDP in 2008 to 108% in 2015, which is far above the threshold set by the Maastricht criteria. The Troika will keep the country under post-programme surveillance until three quarters of its loans are paid off.

The Cypriot economy is still exposed to refinancing and interest rate risks. Interest rates are currently at historical lows in the EU, but cannot hold indefinitely at these levels. Since the end of the Troika's assistance programme, Cypriot government securities are no longer eligible for the ECB's refinancing programme because of their "speculative grade" ratings. To continue to borrow on the markets, the country must convince investors that its fiscal efforts are serious. The road to debt reduction will be long, demanding several years of major fiscal efforts. The IMF's central scenario envisages primary fiscal surpluses of 3.6% of GDP since 2018. Assuming GDP growth of about 2% a year, this will allow Cyprus to reduce its public debt to about 70% of GDP by 2022.

Banking crisis: the worst is over

The Cyprus banking system is still convalescing. On the eve of the 2012-2013 crisis, the country's banking system was over-dimensioned. At its peak in mid-2010, the banking system's total aggregated assets amounted to EUR 170 bn, equivalent to nine times GDP. The Cyprus government lacked sufficient financial resources to rescue such a large-scale banking system. The rescue of Cyprus banks – for the first time in the European Union – required the Troika's support as well as the contribution of the biggest deposit holders (EU deposit guarantees being limited to EUR 100,000). All in all, the big deposit holders, many of whom were non-residents, lost EUR 7.9 bn (47.5% of their assets, on average). After a two-week shutdown, the country's second largest bank went into bankruptcy, while the first, the Bank of Cyprus, benefited from a EUR 9 bn liquidity injection. This rescue operation was a success: in 2014, the so-called "bail-in" approach was extended to all bank rescue operations in the European Union.

In another first for the euro zone, capital controls were installed within the region's borders to prevent a liquidity crisis. Transfers out of Cyprus were drastically restricted in April 2013, but were then eased up a year later and definitely lifted in April 2015. Today the situation seems to have stabilised: even with the summer 2015 turmoil in Greece, it was not necessary to restore emergency measures again.

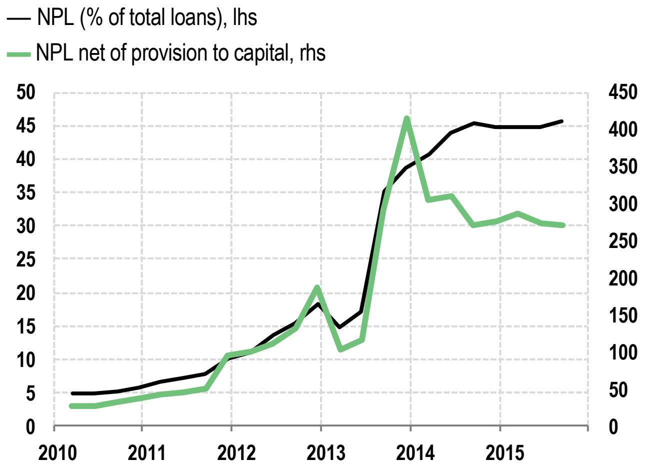
Bank balance sheets still need to be cleaned up

Bank assets dwindled by about half compared to their 2010 peak: end-2015 they accounted for only EUR 88 bn, or five times the country's GDP. Banks have disengaged from government financing and foreign assets. Corporate lending is gradually picking up, rising 4% in 2015. Household lending continued to contract, shedding 6% of its nominal value in 2015.

After racking up heavy losses in 2011-2013, the Cyprus banking sector has swung back into profits. Liquidity has slowly improved: the loan-to-deposit ratio has dropped from 260% in 2010-2011 to 190% in September 2015. The situation is still fragile, however, and future debt reduction efforts will still be needed.

Although the worst of the crisis seems to be behind us, the quality of loan portfolio is still a major problem. In September 2015, the doubtful loan ratio was 46% (chart 2). In absolute value, doubtful loans have levelled off at EUR 28 bn, or 1.6 times GDP. The situation is even more dramatic for household loans, with the NPL ratio of 56%. Provisions are insufficient: net of provisions, non-performing loans still account for 2.5 times the banking sector's capital.

3- Non-performing loan portfolio is still very large



Source: IMF FSI

The IMF welcomed measures adopted in 2015 to facilitate foreclosures of assets in case of non-payment. Together with the measures encouraging banks to restructure their doubtful loan portfolios, they have accelerated the process of cleaning up their balance sheets since Q2 2015. In September 2015, about 17% of total loans had been restructured. As a result, about 4/5ths of these loans have become performing again, thereby avoiding asset seizures.

Once the restructuring process is complete, banks will still have to deal with loan losses. This is a particularly sensitive issue for mortgage loans, which account for 87% of household loans. According to our estimates, the amount of hopeless mortgage loans may reach as high as EUR 2.3 bn to 2.8 bn, or 13-16% of GDP. Such large-scale foreclosures would imply major social risks: therefore a tailor-made solution such as a "bad bank" will probably be necessary to support households and to definitively turn the page on this crisis. A legal framework was adopted in November 2015 that allows the banks to sell loans to third parties.

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