

Economic Outlook for 2015

We are approaching towards the end of another difficult year for the Cyprus economy and we can look back towards what has been achieved with positive feelings. If we take a look at the economic indicators, they are much better than what was originally expected. The real GDP growth rate will probably end up at around -3% (compared to original estimates close to -5%). Actually, the latest figure is even better; at -2.2% for the third quarter of 2014 over the corresponding quarter of 2013. I believe in 2015 might be the year that we finally see positive growth (albeit small). This could come from sectors such as the tourism, trade, as well as the financial and professional services. These were actually the sectors of the economy that exhibited positive growth rates in the last quarter of the year, despite the overall recession.

Inflation is at positive and low level (0.3% for the month of October 2014 according to Eurostat), after a period of deflation that was probably a correction of prices from the levels that we had during the “bubble” years. The expectation is for positive, but low levels of inflation for 2015. This is important because prolonged deflation can be dangerous as it creates barriers to any growth prospects. Unemployment is probably *the* major problem but is beginning to stabilize at around 16% (16.2% is the latest projection from the European Commission projections for Cyprus), after many years of continuous rises. This is an indicator that is more difficult to improve as there is usually a time lag between changes in the macroeconomic indicators and the positive impact that we expect in the labor market. The expectation is for 2015 to see slight decreases in the level of unemployment below the level of 16%.

The budget deficit is also much lower than what was originally expected, projected at around 3% of the GDP with a possible positive primary balance (surplus) despite original estimates of more than 4% of primary deficit. This was achieved through the fiscal consolidation and the control of the government’s expenditures in an effective way. This is to the credit of the government and particularly to the Ministry of Finance although the austerity measures put in place create an obstacle to growth. The expectation is for 2015 to have again a budget deficit, albeit smaller than 3% that we expect for this year. In regards to the trade balance, it continues to be at a deficit and stands at €511 million at September 2014. This trend is expected for the near future as we continue to be net importer of fuels, raw materials, heavy machinery and transportation equipment. In terms of the public debt, it has been kept viable and is projected at around 107.5% of the GDP for 2014, after many years of steep rises. It is expected to peak in 2015 at around 115% of the GDP, and then gradually decline in the coming years.

With regards to the banking system, the restructuring continues after the events of 2013. Our main banks (Bank of Cyprus, Hellenic Bank, and the Co-Operative Society) along with the Russian Commercial Bank passed successfully (almost) the latest ECB stress tests. Hellenic bank was the only one with a shortfall of about €105 million of capital under the adverse scenario of the stress tests, but this is manageable and is expected to be more than covered by the rights issue that the bank is undergoing at the moment. This was a very important step towards recovery although the banks still face pressing issues, especially with the dramatic increase in the non-performing loans that reached almost 48% of the banks/co-ops total credit facilities (for the end of August, 2014). How they will deal with this issue will determine a lot the rate of recovery of

the Cypriot economy. But certainly the banks need to help problematic borrowers with proper restructuring of their loans that could include decreases in the interest rates and/or extension of the loan repayment period. Right now, the interest rate on consumer/business loans is more than 5%, whereas the deposit rate of maturity up to one year is around 2.6%. This margin between the loan and deposit interest rate should gradually shrink to help the economy to recover.

The improvements in the economic indicators and the banking sector did not go unnoticed with the credit rating agencies, that is why all three of them (S&P's, Moody's, Fitch) have been upgrading the Cyprus economy. Of course, we are not out of the woods yet (we are still part of the junk sector that includes high risk/reward), as all of the rating agencies stressed, and more things could have been done, but I believe we are on the right path towards recovery.