

Cyprus Business Forecast Report Q1 2015

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Abstracts

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Core Views

Cyprus is past the worst of its brutal recession. Nonetheless, we do not forecast annual economic expansion until 2016, as credit growth remains impaired, public austerity deepens, and the internal devaluation process keeps a lid on nominal and real wages.

Although the Cypriot government's fiscal consolidation plan has begun to bear fruit, with a reduced deficit, a budget surplus is unlikely to be posted anytime soon. With slow economic growth ahead and chronic budget deficits, Cyprus's debt sustainability may again be called into question at some point in the next few years. Talks to reunify the island have regained some momentum in the past year. While both sides of the dispute still appear to be far apart on the terms of any potential settlement, we believe that negotiations on the 40-year-old 'Cyprus problem' are reaching a crucial phase.

Major Forecast Changes

We have raised our 2015 real GDP growth forecast to 0.0% from -0.2%.

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BMI Political Risk Index

Domestic Politics

Hydrocarbons Raise Stakes For Peace Talks

The peace process between ethnic Greek and ethnic Turkish Cypriots has regained momentum. While both sides of the dispute still appear to be far apart on the terms of any potential settlement, we believe that negotiations on the 40-year-old 'Cyprus problem' are reaching a crucial phase.

Table: POLITICAL Over view

Long-Term Political Outlook

Cyprus Problem, Economy The Dominant Issues

Cyprus celebrated 50 years of independence on October 1, 2010, yet the island remains divided along ethnic Greek and ethnic Turkish lines. Settlement talks between the leaders of the ethnic-Greek South and ethnic-Turkish North have been going for several years with little in the way of progress, and the window of opportunity for finding a resolution is closing. Economic policy will also be at the forefront of discussion in the coming years, as the government struggles to deal with major fiscal austerity and an economic depression. In both cases, the downside risks to long-term stability are limited by strong democratic institutions operating within the EU framework.

CHAPTER 2: ECONOMIC OUTLOOK

SWOT Analysis

BMI Economic Risk Index

Economic Activity

Slow Recovery Ahead, But The Worst Is Past

We maintain our real GDP growth forecast for Cyprus of -3.4% in 2014, but have raised

our 2015 projection to 0.0% from -0.2%. In line with our long-standing view, the economy appears to have clearly turned a corner following three years of contraction. However, the country's recovery will be slow, and activity will not return to pre-crisis levels for the foreseeable future.

Table: GDP Contribution To Growth

Balance Of Payments

External Rebalancing To Continue

We expect a continued narrowing of Cyprus's once-chronic current account deficit over the next five years as the export sector slowly regains competitiveness and imports and foreign financing inflows remain moderate. We forecast a current account balance of -1.6% of GDP in 2014 and -1.0% in 2015, steadily improving over the period to 2018.

Table: Current Account

Fiscal Policy

Government Debt Load To Peak In 2015

The Cypriot government is ahead of schedule in reducing its fiscal deficit, and we project the public sector budget being balanced by

2018. THE PUBLIC DEBT LOAD WILL PEAK AT 119% OF GDP IN 2015 BEFORE GRADUALLY SUBSIDING THEREAFTER.

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ECB Easing: Signs Of Growing Anxiety

The ECB has embarked on additional monetary easing at the September meeting, earlier than we had expected. The ECB's almost knee-jerk reaction to the longstanding deterioration in headline inflation and macro data suggests that the central bank has started to backpedal fast, having previously played down the risks of deflation. We do not view the new measures as a major new expansion of monetary policy, but believe that the ECB's actions and reference to the size of its balance sheet indicate that the tide is starting to turn, and that far more aggressive monetary stimulus could be on the cards.

CHAPTER 3: 10-YEAR FORECAST

The Cypriot Economy To 2023

Long Road To Recovery

Cyprus will continue to experience weak economic growth and a painful structural adjustment process over the coming years that will leave a lasting mark on the domestic consumer and corporate sector alike. Although there is scope for stronger growth to return to the island towards the end of our 10-year forecast period, as the economy enjoys a more solid fundamental picture following a painful adjustment process, as well as benefitting from the emergence of new industries, such as offshore oil and gas, we believe that the wealth destruction along the way will outweigh such benefits through to 2023.

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