

Cyprus Business Forecast Report Q2 2014

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Abstracts

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Core Views

Cyprus' major economic headwinds and ongoing territorial dispute with Turkey will remain dominant themes in policy-making over the coming years. Austerity measures and several years of economic decline could increase social tensions and give rise to marginalised political undercurrents, while efforts to develop offshore mineral resources are set to raise tensions with Turkey within a delicate geopolitical context.

The economic downturn seen in Cyprus likely peaked in 2013, but is set to continue over the next few years as there is little to suggest an improvement in domestic demand. Instead, we caution that the onset of deflation highlights that the current policy mix is ill-fitted for a prompt recovery and will in all likelihood prolong the country's economic malaise for several years to come.

The fiscal situation in Cyprus will continue to improve gradually, although insufficient emphasis is placed on generating higher revenues in the absence of economic growth. While bond yields remain well behaved, we caution that near-term rollover risk and a rapidly rising public debt load could test the sovereign's ability to return to capital markets this year. Although default risk remains muted for the time being, with bond yields below 10%, we believe it is only a question of time before Cyprus will require additional bailout funds.

Major Forecast Changes

We have revised our 2013 real GDP growth forecast from -7.1% to -5.3%. We estimate the current account deficit to have narrowed to 1.4% of GDP in 2013 from our previous

estimate of 3.9% and project a 0.2% of GDP surplus in 2014, having previously forecasted a 1.9% GDP deficit. We changed our nominal budget deficit forecast for 2014 from 3.2% of GDP to 4.4%.

Key Risks To Outlook

One of the biggest risks to our forecast scenario is the prospect of a faster economic correction and a return to positive growth earlier than we currently project. Although the negative wealth effect would likely be the same, the ongoing economic rebalancing and commitment to eurozone membership could see economic growth return sooner.

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Regional Political Outlook

More Eurosceptic Voices Following EU Parliament Election

We expect eurosceptic and populist parties to perform well in the May 22-25 European Parliamentary election, leading to a greater presence of nationalist and pro-withdrawal forces. That said, the pro-EU centre-right European People's Party and centre-left Progressive Alliance of Socialists and Democrats will continue to form the two largest political blocs.

Long-Term Political Outlook

Cyprus Problem And 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 Ratings

Economic Activity

No Quick Fix For Economy Amid Deflation the economic downturn seen in Cyprus likely peaked in 2013, but is set to continue over the next few years as there is little to suggest an improvement in domestic demand. Instead, we caution that the onset of deflation highlights that the current policy mix is ill -fitted for a prompt recovery and will in all likelihood prolong the country's economic malaise for several years to come.

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Current Account Surpluses To Remain In Place From 2014 Onwards

Cyprus' economic rebalancing is paving the way for several years of current account surpluses from 2014 onwards. With little to suggest a return to stronger domestic demand and renewed growth in goods imports, we currently do not see a return to current account deficits for the foreseeable future.

Table: BALANCE OF PAYMENTS (Euro)

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Entering A Lost Decade

Cyprus will continue to experience weak economic growth and a painful structural adjustment process over the coming years that will likely leave a lasting mark on the domestic consumer and corporate sector alike. 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 and as it benefits from the emergence of new industries such as offshore oil and gas. However, we believe that the wealth destruction along the way will outweigh such benefits through to 2023.

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