Popular destination: tourism accounts for 12% of Cyprus's economy

ALL EYES ON CYPRUS'S RECOVERY STRATEGY

Cyprus has suffered a litany of political and economic shocks over the past few decades, but always managed to rebound. Will Covid-19 be a challenge too far? Andrew MacDowall investigates.

The 1974 coup and Turkish invasion; the 1990-91 Gulf War; the Iraq War of the 2010s; a 2011 explosion at a power plant that cut half the country's electricity supply; and the 2013 banking crisis that led to a €10bn bailout. Cyprus has weathered a lot of storms over the past five decades.

"Whenever I am tempted to write off the Cyprus economy because of an unexpected crisis, I am surprised on the upside," says Fiona Mullen, director of Nicosia-based consultancy Sapienta Economics.

AN UNCERTAIN FUTURE

The global coronavirus crisis is the latest storm to break over Cyprus, and it is likely to hit hard. Sapienta forecasts that the economy could contract by anything between 3.5% and a worst-case scenario of 9.2% in 2020, with a baseline scenario of 6.2%.

The range is indicative of the uncertainty over the global impact of the disease, which is likely to affect Cyprus's substantial tourism industry in particular. The sector contributes around 12% of gross domestic product (GDP) overall, according to Sapienta's calculations. This is down from 20% in 2000, which is one reason that Cyprus's economy is somewhat better insulated from the current crisis than might be expected.

"The outlook due to Covid-19 [is that] there should be a substantial hit due to the drop in tourism, although business services should remain resilient," says Alex Boulougouris, co-head of research at investment bank Wood & Company.

On April 3, ratings agency Fitch revised its long-term foreign-currency issuer default rating outlook for Cyprus from 'positive' to 'stable', and affirmed its rating at BBB-, keeping it in investment-grade territory.

Published in a notice issued before the government announced full details of its response to the impact of Covid-19, Fitch's calculations are based on the containment of coronavirus in the second half of 2020 and a subsequent strong recovery into 2021. It noted Cyprus's "structural strength", including GDP per capita and governance indicators comparable to A rated jurisdictions rather than the BBB rated norm.

LAST RESCUE PACKAGE

This strength is partly thanks to the country's robust recovery from the 2013 financial crash, which was triggered by the impact of the Greek economic crisis. This revealed the weaknesses of Cyprus's bloated and overexposed banking sector, which had grown to more than eight times GDP. Non-residents' savings, particularly from Russia and the rest of the Commonwealth of Independent States, accounted for more than half of all deposits, which Cypriot banks pumped into Greek debt.

The crunch saw Cyprus shut out of international capital markets, and led to a €10bn rescue package from the so-called 'Troika' of the International Monetary Fund (IMF), the European Central Bank (ECB), and the European Commission in March 2013. Conditions for the deal included restructuring and downsizing the banking sector, an austerity programme and a range of structural reforms.

Cyprus exited the programme on schedule three years later, having only deployed €7.5bn of the original sum, winning plaudits from the Troika for its effective execution of the reforms and its resumption of stable growth. It has been one of the fastest growing economies in the eurozone in recent years, while the banking sector has been downsized and restructured. Exposure to non-resident deposits has been reduced, and overall assets brought down to less than 300% of GDP.

Unemployment has fallen from a peak of 16.5% in 2014 to 6.3% in 2019, according to the Central Bank of Cyprus, while a budget deficit that reached 5.5% in 2011 was turned into a surplus by 2016. Fitch estimates a surplus of 2.8% in 2019.

SUBSEQUENT RECOVERY

However, the Ministry of Finance's Public Debt Management Office (PDMO) forecasts a deficit of about 4% for 2020, based on an economic contraction of 5% to 9.7%. This is likely to increase scrutiny of Cyprus's debt, which remains one of the highest in the EU. Gross government debt peaked at 109% of GDP in 2014, and has been reduced to 95.5%. Nonetheless, the PDMO says: "Cyprus is dealing with this crisis from a very strong position on its business cycle and from a comfortable fiscal position."

All three major ratings agencies cut Cyprus's sovereign rating deep into junk territory early in the 2010s, but there has been a steady recovery since 2013-14. By 2017, both Fitch and S&P had raised their ratings to investment grade. "Recovery has been very strong, with GDP growth rates close to 3% per year, limited political risks and Cyprus's sovereign bond at record low levels," says Mr Boulougouris.

In January 2020 the government raised €1.75bn through two bond issues. A €1bn 10-year offering sold at a 0.73% yield, while a 20-year €750m bond sold at a yield of 1.3%. The issues should allow the country to pay off part of its IMF loan ahead of schedule, as well as covering budget requirements into the second half of 2020. The offerings attracted the largest total pledge value in Cypriot history, according to finance minister Constantinos Petrides, with the 10-year issue oversubscribed more than sevenfold.

While this partly reflects a global hunt for yield, it is also a sign of investor confidence in Cyprus. It follows several successful issues since the country returned to international bond markets in 2014, including the country's first 30-year offering in 2019.

STIMULUS STRATEGY

On April 6, the PDMO announced plans to raise up to €2bn on international bond markets and €1.25bn in new domestic 12-month Treasury bills, as well as €500m from various other bond issues and supranational loans. The financing moves are part of the government's broader strategy to address the impact of Covid-19, including a €365m fiscal stimulus package, as well as providing a "sizeable cash buffer", given the uncertainty ahead.

"Cyprus government bonds have suffered losses along with other non-core markets in the sell-off," says Chris Attfield, a fixed-income strategist at HSBC. "However, it has fared better than Greece or Italy, despite the smaller size of the market. Along with other southern European countries, it stands to benefit from the ECB's pandemic emergency purchase programme, which we think will keep spreads to Germany under control."

Parliament approved a supplementary budget on March 27, with an overall package worth upwards of €800m, including €100m to enhance the health system, €182m to support private sector workers and €304m to cover the temporary suspension of value-added tax.

The government has also mounted an ambitious €2bn economic support scheme through the banking system, guaranteeing new loans and subsidising interest for individuals and businesses.

In its early April assessment, Fitch noted that Cyprus benefits from a "demonstrated track record" of fiscal prudence and flexibility that stand it in relatively good stead after the "severe short-term shock". But as well as public debt, a current account deficit that reached 6.7% even before the crisis and ongoing legacy issues in the banking sector – where the non-performing loan ratio is still about 30% – are weaknesses.

RISING TO CHALLENGE

"Even though the government has implemented a job-retention programme, assisting businesses and households, it is unclear what the government's finances' burn rate is that can sustain balancing public health and limited economic activity, unless it deploys monetary finance within the eurozone or outside it," says Cleopatra Kitti, a Cyprus-based international consultant and non-executive director.

She notes that Cyprus's post-2013 recovery was achieved in a benign international economic environment, but this time the country faces a deeply uncertain post-crisis world, emerging from what is likely to be a deep global recession. "The global economy is suffering from a crash of supply, demand and cashflow," she says. "With rising unemployment, it is unlikely that there will be much appetite for travel, tourism or expensive real estate – the pillars of the rebound in 2013."

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Plunging oil and gas prices also bode ill for Cyprus's hopes for an economic fillip from the Aphrodite gas field, part of the vast Leviathan basin in the eastern Mediterranean. This was already in doubt thanks to geopolitical tensions in the region, which increased in January 2020 when Turkey deployed a new drilling ship off the south coast of Cyprus. It ramped up what the EU has condemned as illegal operations, and earned a rebuke from the US, which agreed that Turkey was violating Cyprus's exclusive economic zone.

Nonetheless, besides the country's natural strength in tourism, over the long term it has competitive advantages in sectors such as healthcare, education and technology services, says Ms Kitti. "Fiscal discipline safeguarded an upgrade for Cyprus's sovereign credit rating, but the political elites shied away from creating a more contemporary economic model befitting its geographic position and a sustainable place in regional and global value chains," she adds. "Covid-19 will force a rethink and redesign of many economies around the world, including Cyprus." TB