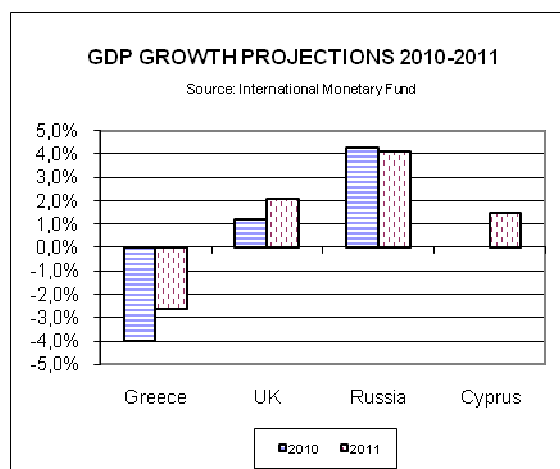


### Three-country update

As a small and open economy, Cyprus is sensitive to economic developments in the rest of the world. Three countries in particular have an important influence on the local economy and are well-worth monitoring closely; the United Kingdom, Greece and Russia. Starting with the UK, it is the country of origin of more than half of the island's tourist arrivals as well as a key source of demand for housing related to holiday, retirement and investment. Russia is the most important country with respect to the international business services sector, as well as a key source of demand for real estate and tourism. Finally, the financial, trade and travel linkages to Greece are very strong, particularly since a number of Cypriot businesses (including banks) have expanded into Greece and many Greek businesses have invested into Cyprus.



Overall, the picture is mixed as Greece is mired in deep recession while Russia on the other hand is expected to grow at a 4 plus percent during 2010-2011. The UK and indeed Cyprus fall somewhere in between, with economic growth in the 0-2% range during 2010-2011. The basic and very simple conclusion that emerges is that, other things being equal, Greece-related businesses should face a much tougher time compared to Russia-related businesses, whereas conditions for businesses that deal with the UK, should be mixed or stable over the next couple of years. Next, the latest and most important developments for each country are examined.

### Greece: Following the IMF program

Greece has started to apply the IMF fiscal and structural reform program since May of 2010 and the first review, in August of 2010, is expected to be approved as it is probably too early to make a reliable decision on how successfully the IMF program is being carried out. According to the IMF's interim report released in mid-July, progress is being made but there are also warnings concerning health, social security and local government expenditure. Given previous experience, the IMF is traditionally sensitive about curtailing such expenditures as sharp and sudden expenditure cuts in these categories can have a major negative effect on public welfare and mood. Given the limited scope of reducing expenditure in these areas, they do pose a risk to the program's goals – something the Greek Finance Minister has also acknowledged.

Another point the IMF is worried about is the high inflation due to an increase in indirect taxes such as VAT and fuel taxes. These higher taxes should have been partly absorbed by shrinking profit margins, yet because of services and product market inefficiencies, they appear to have been passed over to the consumer. Inefficient product markets and certain services and the challenge of structural reforms, are therefore an additional area of concern. Inflation because of higher taxes is a one-off phenomenon, but it is worth reminding that this high inflation makes an existing competitiveness problem even worse in the short run. On a more positive note, the banking system appears so far to be coping ok with the debt crisis and Greek banks were set to successfully pass the EU-mandated stress tests, while the government is pressing for mergers and other strategic moves in order to consolidate the sector. Another positive development was that the government managed to successfully auction some short-term debt in the form of 26-week and 13-week T-bills.

Because the IMF program is still in its initial stages, there is still high uncertainty regarding its final outcome. Despite bond purchases by the European Central Bank and the country's commitment to the IMF program, the market is still expecting a default, given the prices at which Greek sovereign bonds trade. The economy is expected to deteriorate further during the next 12 months and 2010 will be the worst year of the past 4 decades. Stabilization is expected in the second half of next year. Given this backdrop, social unrest and mobilizations could increase and demonstrations and labor disputes could become a permanent feature of Greece. Major strikes and demonstrations have attracted much negative publicity for Greece and the tourism sector has been hit hard despite a global uptick for the travel and leisure sector this year. These risks, combined with the recent unwelcome reminder of Hungary where a newly elected government challenged the previous government's commitment to the EU/ IMF program and said 'no more austerity', showcase some of the dangers that are present.

Looking at recent statistical releases, credit expansion during April accelerated to a 6,1% annual pace, as credit to the public sector rose by an annual 19,1% whereas credit to business and households decelerated to a 3,2% growth rate. Credit to households was growing at a 2,5% pace while businesses were posting a relatively healthier 3,9% loan growth. The private sector remains underleveraged compared to the public sector.

With respect to retail sales by volume, they fell 5,8% in April after a 10,1% rise in March. The rise and subsequent fall in retail sales was related to the bulk of the shopping for Orthodox Easter, which occurred in March during 2010 and in April during 2009. Retail sales are expected to stay in negative territory for the rest of the year as unemployment continues to rise. Speaking of unemployment, it rose to 11,9% in April compared to 11,6% in March. According to IMF projections, unemployment is expected to rise to the 14,5-15,0% range during 2011 and 2012. Finally, inflation came in at 5,2% during May compared to 5,4% during April, which was a 13-year high because of indirect tax rises and unfavorable base effects. Inflation is expected to drop during 2011, although it remains to be seen whether it will drop under the EU average for a sustained period of time in order to restore competitiveness.

### **UK: recovering but only just**

The UK economy is slowly recovering following a brutal -4,9% recession during 2009. The recovery, which is in the magnitude of 1-2% GDP growth during 2010 and 2011, will be tested by the fiscal consolidation effort underway by the new coalition government between the Conservatives and the Liberal Democrats. Furthermore, while consumption was stronger-than-expected during the second quarter – partly because of the World Cup effect- falling consumer confidence, high unemployment, low wage growth, high debt levels, high fuel prices and the increase of VAT tax to 17,5% in January of 2011, are likely to weigh on consumption in the future. It is worth noting that unemployment in the UK was not particularly high compared to other countries at 7,8% during May (ILO definition) and private economists expect it to stabilize at 8,0% by the end of next year despite expected job cuts in the public sector.

Besides the consumer, another question mark is over interest rates. The Bank of England is generally credited as being proactive enough during the crisis so as to have slashed interest rates to 0,5% and resorted to quantitative easing of 200 billion pounds, in order to stave off deflation and resuscitate the economy. The worst might have been avoided, but now inflation is way over the Bank's target of 2% (at 3,2% during June) and is likely to remain over target until the end of 2011 because of the VAT hike. In addition, quantitative easing has not restored the flow of credit, as net lending to businesses fell for three consecutive months in May and as mortgage approvals were at their lowest in a year during the same month. Given the weak economic prospects as well as the global headwinds coming from the Eurozone debt crisis and a slowdown in the United States, some Bank of England policymakers have even started to consider cutting interest rates, according to the latest Monetary Policy Committee minutes.

House prices are another question mark as annual house price growth has slowed down during the past few months and has indeed posted a monthly fall during July, as more houses are coming up for sale at the same time as the number of mortgage approvals is low and buyers are struggling to secure mortgage financing. According to property website Rightmove, the second half of 2010 is likely to wipe out the housing price gains of the first half because of weaker economic conditions and fiscal consolidation. Valuation wise, according to Halifax, the average house price to earnings ratio is at 4,7 times, which is higher than the average of just 4 times post-1983, suggesting house prices have room to fall further, given that household earnings are unlikely to bounce higher anytime soon given the state of the labor market.

In conclusion, the UK economy is expected to post positive growth over the next year and a half, but it is still struggling with some serious challenges such as the need for drastic fiscal consolidation, weak lending to the private sector, unwanted inflation, global headwinds from the Eurozone and the United States and possibly a weak housing market.

### **Russia: not yet feeling the global chill**

Russia appears to be one of the few economies that is not yet experiencing a slowdown because of the recent deterioration in global growth prospects caused by uncertainty in developed economies such as the Eurozone and the United States.

During June, the Russian economy grew by a 4,9% annual pace, following the 7,9% contraction it recorded during 2009 – the year which marked its worst economic performance in 15 years. For the whole of 2010, growth is expected to come in at around 4,0% - although that forecast may be raised.

Russia is facing a problem that is widespread in other fast-developing emerging markets too; mainly how to switch from export-led growth and boost domestic demand. In Russia's case, the economy is very reliant on exports of natural resources, particularly energy. In addition, the Russian authorities would like to boost private investment as opposed to state-sponsored investment, as a means of boosting domestic demand as well. According to the Central Bank Chairman, bank lending, which is crucial for domestic investment, has started to pick up during the second quarter although it remains slow at 3-4%. Lending is hampered by high credit risks and the unwillingness of borrowers to take out new loans at the interest rates which banks charge, according to the Chairman.

With respect to industry, there was some slowdown of production in June because of lower demand for commodities extraction as well as distribution of electricity, gas and water – most probably linked to slowing exports due to the European debt crisis. On the other hand, car manufacturing picked up because of a government scheme to get rid of older vehicles. There was also healthy activity with respect to construction; a sector that is expected to boost the economy's prospects in the medium-term. Industrial production is expected to rise in the 8-10% range during 2010.

One point there is some debate over is whether rouble interest rates will head higher or lower in coming months. After 14 consecutive rate cuts which occurred over 13 months, the key refinancing rate fell to 7,75% in May. According to its most recent monetary policy statement, the Bank of Russia expects interest rates to stay constant in coming months. The consensus among analysts until recently was that interest rates would start to head higher at the end of 2010 or at the beginning of 2011, as inflation would start to pick up from the 6,0% May level. In June however, inflation dipped to 5,8% and some analysts believe that if inflation heads even lower and the rouble continues its climb, the Central Bank could cut rates further. Inflation, the level of the rouble and of course the global economic recovery and its influence on commodity prices, are probably the most important variables that the Central Bank will have to take into account in setting interest rates over the coming months.