SUMMARY

Growth in 2016 is expected to strengthen, as real GDP is forecasted to expand by 2.4%. The y–o–y percentage change of GDP is projected at 2.2% and 2.1% for the first and second quarter of 2016 respectively, and at 2.7% for the second half of the year.

The main drivers of the projected increase in real activity are given below.

- The growth rate (y–o–y) of real GDP and employment strengthened, while unemployment declined in the final quarter of 2015; many domestic leading indicators continued to improve in the first quarter of 2016.
- Declining international oil and non–energy commodity prices that put downward pressures to the aggregate price level are expected to benefit activity through their effects on real incomes and demand.
- The downward trend in domestic lending interest rates, amid conditions of weak demand and elevated unemployment as well as stronger normalisation tendencies in the banking system, facilitate the recovery.
- Domestic economic confidence strengthened further in the fourth quarter of 2015 and during the first quarter of 2016 leading to an improved outlook for 2016.
- The fiscal performance that has been bridging the gap between government expenditure and revenue is expected to positively contribute to a sustainable recovery.

Strong economic confidence and the expansion of activity in the EU and the euro area – as well as the low levels of European lending interest rates – have been supportive of the recovery in Cyprus. Nevertheless, some recent developments in foreign leading indicators (confidence, zero/negative interest rates, stock market returns) that provide signs of a less favourable external economic environment are found to have some dampening effect on domestic growth, revealing the vulnerability of the Cypriot economy to global conditions.

Downside risks to the growth projections are associated with the following factors.

- The high levels of non–performing loans continue to pose major risks to the stability of the banking system and to the outlook for the economy. Ineffective implementation of the new insolvency and foreclosure legal framework could delay the resumption of healthy credit conditions and sustainable economic growth; thereby, prolonging the uncertainty in the property market, which feeds back into banks’ balance sheets.
- Loss of momentum in structural reforms may create risks to public finances, Cyprus’s credibility and market borrowing costs.
- Deterioration of the external economic environment for Cyprus due to the following: (a) continuation of the recession in Russia (oil exporter) in conditions of protracted declines in oil prices; (b) weaker than expected growth in the euro area as a result of worsening global economic conditions; and (c) slower than expected growth in the UK and further weakening of the pound against the euro as a result of a global slowdown and the political uncertainty regarding the future of the country in the EU.
- Political uncertainty in Europe triggered by, for example, Britain’s potential exit from the EU or the handling of the refugee crisis, could lead to increased economic uncertainty and undermine economic confidence.

Upside risks to the outlook relate to a longer period of lower international oil prices, investment decisions linked to the sectors of tourism and energy as well as public investment projects.

CPI inflation in 2016 is projected at −0.8%. The negative inflation projection is driven by further declines in international oil prices and lower international prices of non–energy commodities combined with sluggish demand.
1. Recent developments

Economic growth in Cyprus strengthened further in the fourth quarter of 2015 as real GDP increased by 2.7% year-on-year (y-o-y) compared to 2.3% in the third quarter. After three years of decline in economic activity, real GDP expanded by 1.6% in 2015. In the final quarter of 2015, the real gross value added in all sectors increased (y-o-y). Growth in the last quarter accelerated significantly in construction but slowed down in the sector of financial and insurance activities after two quarters of robust performance. The expansion (y-o-y) of private consumption continued to firm and fixed investment rose (y-o-y) as a result of investment in housing construction. Imports grew more strongly than exports in the fourth quarter but net exports remained positive.

Many domestic leading indicators continued to pick up in the first months of 2016 (e.g. credit card usage by locals and tourists, registrations of motor vehicles, cement sales, registrations of new companies, tourist arrivals). The Economic Sentiment Indicator (ESI) strengthened further during the first quarter due to confidence improvements in services, retail trade and construction. Also, firms’ employment expectations were more optimistic in the first quarter of 2016 compared to the second half of 2015.

The increase in deposits speeded up in January – February 2016. The decline in domestic loans registered in the last quarter of 2015 accelerated in January – February, but loans to domestic non-financial corporations continued to grow. Lending interest rates in the first two months of 2016 remained below the levels recorded during the corresponding period in 2015.

The ratio of non-performing exposures to total facilities (local operations) declined in November – December of 2015 after it peaked in October. Nevertheless, the high level of non-performing loans remains a major challenge to the banking system and the economy at large. The unemployment rate (Eurostat) has been falling throughout 2015 and during January – February 2016; it is currently standing at slightly below 13% which is the lowest rate that has been recorded since 2012. Moreover, the number of registered unemployed continued to fall in the first quarter of 2016. During the first two months of 2016 general government revenue increased (y-o-y) while expenditure decreased leading to a larger surplus compared to the same period in 2015.

The general price level (measured by the Consumer Price Index – CPI) in the first quarter of 2016 decreased at a slightly faster pace compared to the last quarter of 2015. Deflation was driven by lower prices in the categories of housing–water–electricity–gas and transport as a result of further reductions in international oil prices as well as by price declines in the food category.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the fourth quarter of 2015. Monthly indicators released by 12 April 2016 that contain information covering at most all the months in the first quarter of 2016 are also used. All forecasts presented in this bulletin are based solely on published data; thus, they only incorporate effects already captured by the quarterly series and the monthly leading indicators used in the estimations.

The forecasts for the y-o-y growth rate of real GDP for all the quarters of 2016 are shown in Table 1; a projection for the whole of 2016 is also provided. ¹

- Based on the historical relationships between growth and numerous macroeconomic indicators, real GDP growth in 2016 is estimated to strengthen as real GDP is forecasted to expand by 2.4%.
- The y-o-y percentage change of GDP is projected at 2.2% and 2.1% for the first and second quarter of 2016 respectively, and at 2.7% for the second half of the year.
- The y-o-y growth rates given in Table 1 imply quarter-on-quarter (q-o-q) percentage changes of 0.7% for the first half of 2016 and of 0.8% for the second half of the year, slightly stronger than the q-o-q growth rates in the second half of 2015.

Table 1 presents also the forecast errors associated with the estimated y-o-y growth rates in each quarter; errors are larger for quarters closer to the end of the forecast horizon. Furthermore, Table 1 shows the contribution of different components (groups of models) towards shaping the final forecasts. Real economy factors (domestic and international

¹ The forecasts for the y-o-y growth rate of real GDP reported in the table are obtained via the estimation of a large number of alternative models embracing various aspects of the economy. The final forecast for each quarter presented here is computed as the weighted average of all model forecasts using weights based on the historical forecasting performance of each model.
activity and labour market) and components in the group which excludes real economy factors have a minor effect on the formation of the forecast in all quarters (about 1.0%). However, real economy factors jointly with other economy aspects play a key role in determining the forecasts.

The main drivers of the projected increase of real economic activity are discussed below.

The growth rate ($y-o-y$) of real GDP and employment strengthened in the final quarter of 2015 and the unemployment rate fell to about 13% over the same period. Unemployment subsided further in January – February 2016 and the decline in the number of registered unemployed accelerated during the first quarter of the year, signalling less adverse labour market conditions. Many activity-related domestic leading indicators (e.g. tourist arrivals, credit card usage by locals and tourists, registrations of motor vehicles, cement sales, new company registrations) continued to pick up over January – March 2016.

Declining international oil prices and subdued non-energy commodity prices that put downward pressures to the domestic and EU aggregate price level are expected to benefit economic activity in Cyprus through their effects on real incomes and both domestic and external demand.

The downward trend in domestic lending interest rates amid conditions of weak demand and elevated unemployment continues to add to growth. Stronger normalisation tendencies in the domestic banking sector, indicated by the recent increases in domestic deposits and business loans are also found to facilitate the economic recovery.

Domestic economic confidence strengthened further in the fourth quarter of 2015 and during the first quarter of 2016 leading to an improved outlook for 2016; the level of ESI for Cyprus is currently above that of the euro area and EU average index.

The fiscal performance that has been bridging the gap between government expenditure and revenue is expected to positively contribute to a sustainable recovery.

Although strong economic confidence and the expansion of activity in the EU and the euro area as well as the low levels of European interest rates have been supportive of the recovery in Cyprus, some recent adverse developments in foreign leading indicators reveal the vulnerability of the Cypriot economy to external conditions.

The European economic sentiment indicators rose further in the final quarter of 2015 but growth in the EU and the euro area remained modest during the same period. Throughout the first quarter of 2016, economic sentiment indicators for the EU and the euro area were falling, suggesting a rather weaker growth momentum in the following quarters.
The new reductions in recent months that drove European interest rates to negative territory, and the prolonged period of near-zero interest rates in the euro area, also reflect conditions of sluggish demand, particularly investment, and therefore uncertainties about the bloc’s growth momentum.

Increased volatility in the international stock markets in recent quarters and their underperformance during the first quarter of 2016 signal risks about global growth prospects, especially activity in emerging markets. Moreover, the June referendum on the EU membership of the UK increases economic uncertainty in Europe, most notably in Britain. The British pound has been weakening against the euro since December 2015.

All the above external developments reflected by the recent movements of various leading indicators are found to have some dampening effect on domestic growth as they adversely affect real external economic conditions as well as economic confidence.

There are both downside and upside risks to the outlook relating to both domestic and external factors. The downside risks associated with the external environment have intensified. Downside risks to the growth projections are discussed below.

- The high levels of non-performing loans continue to pose major risks to the stability of the banking system and to the outlook for the economy. Ineffective implementation of the new insolvency and foreclosure legal framework could delay the resumption of healthy credit conditions and sustainable economic growth, and prolong the uncertainty in the property market which feeds back into banks’ balance sheets.

- Loss of momentum in structural reforms after the end of the economic adjustment programme may create risks to public finances, Cyprus’s credibility and market borrowing costs.

- Deterioration of the external economic environment for Cyprus due to the following:
  a) continuation of the recession in Russia (oil exporter) in conditions of protracted declines in oil prices;
  b) weaker than expected growth in the euro area as a result of worsening global economic conditions, especially a downturn in emerging market economies;
  c) slower than expected activity growth in the UK and further weakening of the pound against the euro as a result of a global slowdown and the political uncertainty regarding the future of the country in the EU.

- Political uncertainty in Europe triggered by, for example, Britain’s potential exit from the EU, or the handling of the refugee crisis, could lead to increased economic uncertainty and undermine economic confidence.

The IMF revised Russia’s growth forecasts for 2016 downwards, estimating a larger contraction in output than in its previous release [3]. Also, the IMF revised downwards the 2016 growth projections for the euro area and the UK [3]. The ECB is currently projecting a smaller output growth rate for the euro area compared to its previous forecast [1].

Upside risks to the outlook relate to both external and domestic factors. A longer period of lower international oil prices leading to lower energy costs will have positive effects on domestic activity. On the domestic front, investment decisions linked mainly to tourism and energy as well as public investment projects could improve the economy’s prospects.

CPI inflation in 2016 is projected at −0.8%.

3 The negative inflation projection is driven by further declines in international oil prices and lower international prices for non-energy commodities combined with sluggish demand. Upside risks to the forecasts relate to stronger demand, the weakening of the euro against the US dollar and increases in international commodity prices. Downside risks to the projections are associated with weaker than expected demand, a more prolonged period of lower international oil prices and entrenched deflationary expectations.

3 CPI inflation forecasts are constructed using a methodology similar to that for GDP growth forecasts (see footnote 1).

3. Concluding remarks

Quarterly data available up to the fourth quarter of 2015 and monthly indicators for the first quarter of 2016 released until 12 April 2016 are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

The forecast for real GDP growth for 2016 is revised from 2.7% in the January issue to 2.4%. The downward revision resulted from the slightly lower than forecasted real GDP growth rate in the final third quarter of 2015 in Cyprus, failure
of growth in the EU and the euro area to accelerate in the last quarter of 2015 and a worsening in a number of foreign leading indicators in the first quarter of 2016 (European economic sentiment, international stock market indicators, negative European interest rates) suggesting some deterioration in the external economic environment.

The forecast for CPI inflation in 2016 is revised downwards from 0.3% in the January issue to –0.8%. The downward revision resulted from an acceleration in deflation during the first quarter of the year mainly associated with further declines in oil prices and subdued demand.

The forecasts for 2016 presented in this issue suggest that real activity will continue to improve. The growth forecast for 2016 given in this bulletin is more optimistic than the growth rate projected by the European Commission and the IMF [2], [3]. The forecasts analysed in this bulletin are accompanied by upside and downside risks related to both domestic and external factors, with the external environment currently posing more risks compared to the January issue.

The econometric analysis based on the currently available data suggests that the economic recovery in Cyprus will continue at a somewhat faster pace in 2017.

REFERENCES


APPENDIX

Table A1: GDP growth (y–o–y) forecasts, components of forecasts, weights and forecast by component

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