As a result of the COVID–19 pandemic, real economic activity in Cyprus is projected to contract sharply in 2020. Real GDP growth in 2020 is projected at −7.5%. The growth forecast incorporates the unprecedented negative developments in many indicators over the period March – June, as well as the effects of a negative shock to external demand for tourist services due to the pandemic; the shock is assumed to impact several branches of the economy for the rest of 2020.

The negative outlook for 2020 is mainly driven by the sudden slowdown in domestic activity and the output contraction in Europe in the first quarter of the year, the collapse of economic sentiment in Cyprus and the EU, as well as the adverse performance of financial markets and heightened market volatility in the previous months. Nonetheless, there are some factors that are expected to mitigate the downturn. These factors include: (i) the increased government expenditure to alleviate the effects of the pandemic; (ii) the recent declines in international oil prices and the absence of upward price pressures that back real incomes; (iii) the low levels of domestic and European interest rates.

In 2020, CPI inflation is projected to fall to −0.7% from 0.3% in 2019, driven by the recent sharp declines in international oil prices and weak demand due to the COVID–19 pandemic.
1. Recent developments

In the first quarter of 2020, real GDP growth in Cyprus decelerated abruptly to 0.8% (year-on-year) from 3.2% in the final quarter of 2019. The outbreak of the COVID–19 pandemic and the unprecedented containment measures that followed disrupted economic activity globally, including in Cyprus.

After a long period of robust growth, the sectors of industry, construction, trade and transportation, as well as arts, entertainment and other services contracted in terms of gross value added, while the remaining sectors registered positive growth rates in the first quarter. Private consumption growth slowed down in the first quarter; the consumption expenditure of the general government increased strongly. Gross fixed capital formation also recorded strong growth in the first quarter, driven by higher investment in transport equipment; nevertheless, construction investment shrank. Net exports had a negative contribution to growth in the first quarter, as a result of a decrease in exports.

The deterioration in domestic leading indicators between March and May was of unprecedented magnitude, as the containment measures enforced to curb the spread of the virus in Cyprus halted a large part of economic activity. In June, a number of domestic leading indicators has shown signs of recovery, as the economy has been successfully reopening against a backdrop of favourable epidemiological conditions in the country.

In the second quarter of 2020, the Economic Sentiment Indicator (ESI) dropped well-below its historical average and to levels that are consistent with recessionary conditions. The largest confidence losses were registered in services and industry, as confidence indicators fell to all-time lows between April and May. Compared to the large-scale downward revisions in activity expectations, the revisions in firms’ employment expectations in the second quarter were much smaller, due to various government schemes in place for supporting employment and businesses. In May, when the gradual lifting of the containment measures began, the ESI has started recovering. However, survey data point to heightened uncertainty among both firms and consumers regarding their future financial conditions.

The number of registered unemployed rose at double-digit rates in the second quarter after a six-year downward trend; the largest increases were recorded in the sectors of restaurants and hotels, transportation, and trade. The unemployment rate (Eurostat) increased to just above 10% in May.

The strong fiscal performance in Cyprus in 2019 and in the first two months of 2020 created the space for a swift adoption of a fiscal package in mid–March to alleviate the consequences of the pandemic in the country. The measures aim at safeguarding employment, providing liquidity to businesses and avoiding company failures, supporting the self-employed, and strengthening the health care system. Additional targeted schemes to support employment and businesses affected by the pandemic were announced in June. Consequently, government expenditure rose sharply, while revenue plunged in April – May, resulting in a sizeable deficit; public debt also increased to meet the new needs. In the second quarter of 2020, long-term interest rates for Cyprus rose from the historically low levels registered in the previous quarters.

During the second quarter of 2020, domestic deposits continued to grow, albeit at slower annual rates compared to the first quarter. The stock of domestic loans has registered weak growth throughout the first half of the year, but new loans contracted considerably during January – May. According to the most recent data, the ratio of non-performing loans to total exposures was at about 28% in February, remaining a major vulnerability for the economy, particularly in view of a worsening outlook. Nevertheless, domestic lending interest rates have remained at very low levels and various measures announced to counteract the economic effects of the pandemic (e.g. suspension of loan instalments, short–term restructurings of loans, interest rate subsidisation of new housing and business loans) are expected to support business liquidity, investment, as well as household incomes.

Inflation (measured by the Consumer Price Index – CPI) turned negative in the second quarter of 2020, at -1.6% from 1.1% in the first quarter, as international oil prices and demand collapsed due to the pandemic.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using an extensive dataset of domestic and foreign indicators, as well as a large number of dynamic econometric models. Quarterly series available up to the first quarter of 2020 are employed. Monthly indicators that contain information about some or all the months in the second
quarter of 2020 are also used. The cut-off date for the data used in the analysis is 17 July 2020.

The unprecedented negative developments in a large number of forward-looking indicators over the period April - June reflect the following: (i) the economy’s reduced production capacity during the lockdown period (April – early May); (ii) the lower capacity at which the economy has been operating due to measures/restrictions (e.g. social distancing, increased hygiene requirements) while gradually reopening (early May onwards); (iii) the collapse in external demand, particularly the demand for tourist services (April – May).

The leading indicators published until the cut-off date capture the disruption in economic activity in the second quarter of the year to a large but not full extent. In particular, tourist services are expected to be heavily affected beyond the data cut-off date as the pandemic has restricted international travel significantly. Moreover, travel from the two main markets of the Cypriot tourist product, the UK and Russia, has been subject to restrictions and bans. Tourist services make up a large part of economic activity in Cyprus and the reduction in external demand due to the pandemic can be viewed as an exogenous shock that impacts a number of branches of the economy. This shock is simulated by a decrease of about 80% in annual tourist arrivals, and its impact is incorporated in the GDP forecast for 2020 shown in Table 1.1 Furthermore, Table 1 shows the contribution of different components (groups of models) towards shaping the final forecast. The real economy component—based on factors estimated from domestic and international real activity and labour market indicators—and the component relating to economic aspects other than the real economy, have a minor contribution to the overall forecast.2 The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecast.3,4

Based on the historical relationships between growth and numerous macroeconomic and financial indicators, as well as on the above assumption about external demand, real economic activity in Cyprus is forecast to suffer a severe contraction in 2020 as a result of the pandemic. Real GDP is projected to contract by 7.5%.

The abrupt decline in economic activity is driven by the deterioration in domestic and external economic conditions,

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1 The y-o-y reduction in tourist arrivals over the period January - June 2020 is 84%.
2 Factors refer to a small number of principal components extracted from a large dataset of series relating to real domestic and foreign activity, and the labour market. The component relating to aspects other than the real economy is based on indicators such as interest rates and spreads, stock market returns, economic sentiment indicators, exchange rates, domestic and foreign price indices, international commodity prices, as well as fiscal and banking sector series (loans, deposits).
3 Monthly leads of leading indicators (e.g. interest rates, economic sentiment) and monthly leading values of series used in extracting the factors (e.g. unemployment rate, registered unemployed, arrivals of tourists, registrations of motor vehicles) are also included in the models.
4 Economic sentiment indicators refer to data obtained through the Harmonised Programme of Business and Consumer Surveys conducted by the Directorate General for Economic and Financial Affairs. The Economics Research Centre acknowledges funding from the European Union, the Ministry of Finance and the University of Cyprus for conducting the ‘Business and Consumer Surveys’ project in Cyprus.
reflecting both production constraints and demand shortfalls. Specifically, the negative outlook for 2020 is driven by the following:

• **Slowdown in domestic activity and output contraction in Europe.** As a result of the outbreak of the pandemic and the containment measures that followed, domestic activity decelerated considerably in the first quarter after a long period of robust growth, and real GDP in the EU contracted abruptly. Domestic leading indicators point to a significant worsening of activity and labour market conditions in the second quarter, especially in relation to tourism services, construction and manufacturing. Moreover, the impact of the adverse shock to external demand for tourist services in Cyprus weighs heavily on the outlook. This shock is expected to have particularly adverse effects on branches of economic activity relating to tourism, i.e. trade, transportation, accommodation and food service activities, administrative and support service activities (e.g. travel agencies, tour operators, car rentals), and arts, entertainment and recreation. The above-mentioned sectors are associated with large negative contributions to the projections as shown in Table 2. The sectors of construction, industry and, to a smaller extent, real estate activities are also expected to put a drag on GDP growth in 2020 due to weak demand.

• **Collapse of economic sentiment.** Economic confidence among businesses and consumers in Cyprus and the EU sank in April – May to levels similar to those recorded during the 2013 crisis and the financial crisis, respectively. Although, economic sentiment has shown signs of recovery in June, all confidence indicators are currently at very low levels and economic uncertainty is elevated. Survey data suggest a more severe downturn in Cyprus in 2020 than other indicators (Table 1).

• **Adverse performance of stock markets and high market volatility.** The negative performance of international stock markets and the spikes in volatility in the first quarter of 2020 reflected the sudden deterioration in the global economic conditions due to the pandemic. These recent developments in international stock markets affect the outlook negatively, particularly in combination with the worsening of conditions in the real economy. Nonetheless, there are some factors that are expected to mitigate the downturn. These factors include the following: (i) the increased government expenditure to alleviate the effects of the pandemic; (ii) the recent declines in international oil prices and the absence of upward pressures on the general price level that back real incomes; (iii) the low levels of domestic and European interest rates, reflecting the supportive monetary policy conditions in the euro area. Thus, some sectors of economic activity, such as public administration and health, as well as financial and insurance activities, are expected to have positive contributions to GDP growth in 2020 (Table 2).

The uncertainty surrounding any macroeconomic projection at this juncture is extremely high. Worsening epidemiological conditions and setbacks in the complete reopening of the economy pose downside risks to the outlook. Also, a more negative path of tourist arrivals in Cyprus than the one assumed, a deeper and/or a more prolonged global downturn than it is currently anticipated, as well as rising geopolitical tensions in the Eastern Mediterranean could lead to a larger contraction in GDP than that projected. Legacies from the previous crisis, such as the high level of public and private debt and the high stock of non-performing loans, render the economy less resilient to the COVID–19 crisis. Thus, additional risks relate to fiscal pressures arising from the current crisis, and a possible re–escalation of non-
performing loans, particularly after the expiry of the various support schemes, and therefore more relevant to the medium term.

Upside risks to the outlook include steadily improving epidemiological conditions both in Cyprus and abroad, which would positively affect demand, a faster-than-expected development of a vaccine, and positive confidence effects from the newly announced EU recovery plan.

In 2020, CPI inflation is projected to fall to -0.7% from 0.3% in 2019, driven by the recent sharp declines in international oil prices and weak demand due to the COVID-19 pandemic. Upside risks to the forecasts include a faster rebound in international energy prices and demand. Downside risks to the inflation outlook are associated with a deeper and/or a more protracted downturn in domestic and global activity than that is currently foreseen, as well as further downward pressures on international commodity prices.

3. Concluding remarks

The outbreak of the COVID-19 pandemic has necessitated containment measures that have severely disrupted economic activity globally, including in Cyprus. The growth forecast for 2020 incorporates the unprecedented negative developments in a large number of indicators over the period March – June, as well as the effects of a shock to external demand for tourist services due to the pandemic; the shock is assumed to impact several branches of the economy for the rest of 2020.

Real GDP in Cyprus is projected to decline by 7.5% in 2020. This is a downward revision by 0.6 percentage points compared to the projection in the May issue (baseline scenario), as a result of the abrupt deterioration in almost all indicators between March and June, leading also to a more adverse assumption about the evolution of external demand for tourism services in Cyprus until the end of the year. In 2020, CPI inflation is projected to turn negative, at -0.7% driven by the recent declines in international oil prices and weak demand.

The growth forecast is close to the projections published by the Central Bank of Cyprus (-7.3%) and the European Commission (-7.7%) [1] - [2].

REFERENCES

The bulletin "Economic Outlook" publishes results of research in the Sector of Macroeconomic Forecasts and Analysis of the CypERC. The bulletin reflects only the authors’ views. The views expressed in this bulletin do not necessarily reflect those of the CypERC Academic Advisors, the CypERC Council or the CypERC Sponsors.

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