SUMMARY

The recovery of economic activity in Cyprus is forecasted to continue in the following quarters. Real GDP growth for 2015 is projected at 1.5%. Real output growth for the fourth quarter of 2015 is estimated at 2.8%. Growth is expected to gain momentum in 2016, as real GDP is forecasted to expand by 2.7%.

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 in the third quarter of 2015, and many domestic leading indicators continued to improve during the final quarter of 2015.
- The recent reductions in domestic lending interest rates, amid conditions of weak demand and high unemployment, as well as stronger normalisation tendencies in the banking system facilitate the recovery.
- Domestic economic confidence strengthened in 2015, despite some short-lived setbacks related to developments in Greece; a further upturn in all domestic sentiment indicators in the fourth quarter of 2015 is found to improve the outlook.
- Lower international oil prices, downward pressures to the domestic aggregate price level and low inflation in the EU are expected to assist recovery through their effects on real incomes and demand.
- Modest growth in the euro area and steady growth in the UK as well as further increases in European economic sentiment indicators support the recovery in Cyprus by creating favourable foreign demand conditions.
- The weakening of the euro against key currencies, most notably the British pound, is expected to boost domestic activity in the following quarters through exports, particularly tourism services.
- Reductions in the European lending interest rates during the second half of 2015 reflect ECB’s accommodative monetary policy stance, which is supportive of the recovery process in Cyprus.

Downside risks to the growth projections are associated with the following:

- The high levels of non–performing loans 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 robust economic growth.
- Delays in the implementation of structural reforms agreed in the economic adjustment programme (e.g. public administration, privatisations, health system) may create risks to public finances, Cyprus’s market borrowing costs, especially after the end of the economic adjustment programme, and to activity.
- Deterioration of the external economic environment for Cyprus due to (i) the recession in Russia, (ii) weaker than expected growth in the euro area and the UK, as a result of a slowdown in emerging markets, especially in China, and (iii) heightened geopolitical tensions in eastern Mediterranean.

Upside risks to the outlook relate to the following:

- A longer period of lower international oil prices leading to lower energy costs with positive effects on domestic activity.
- Investment decisions linked mainly to tourism and energy, as well as public investment efforts for the expansion and/or improvement of infrastructure.

Renewed recession in Greece is not likely to have negative effects on Cyprus due to the recent weakening of connections between the banking systems of the two countries. The worsening of the Greek economic outlook alone is not expected to reverse the recovery in Cyprus.

CPI inflation in 2016 is projected at 0.3%. The low inflation projection is driven by the lower international oil prices and by price declines in the international prices of non–energy commodities combined with sluggish domestic demand. Inflation is projected to pick up in the second half of the year as activity and demand will continue to firm up.
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1. Recent developments

Economic growth in Cyprus strengthened further in the third quarter of 2015 as real GDP increased by 2.2% year-on-year (y–o–y) compared to 0.8% in the second quarter. All sectors apart from arts, entertainment and other services expanded y–o–y in terms of their gross value added. On the demand side, growth in the third quarter was driven by the expansion of private consumption and exports as well as by a drop in imports. Fixed investment contracted in the third quarter, although growth in housing construction investment picked up during the same period.

Many domestic leading indicators continued to rise or improved further in the last quarter of 2015 (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 significantly during the fourth quarter due to confidence improvements in all sectors and among consumers. Domestic deposits have registered positive growth rates in September – November for the first time since 2012. The weak increase in domestic loans in the first three quarters of 2015 was reversed in October – November, but loans to non–financial corporations continued to grow. Lending interest rates in the second half of 2015 remained below the levels recorded in the first half of the year, backing the recovery of economic activity.

The level of non–performing loans (local operations) rose further in October, but the amount of restructured loans showed an upward trend during January – October 2015. 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) declined further in the third quarter of 2015 and the number of registered unemployed continued to fall in the fourth quarter; yet the unemployment rate which is currently hovering at 15% is amongst the highest in the euro area. General government budget balance turned negative in October – November as revenue decreased and expenditure increased over the same period; for January – November a primary surplus was recorded.

The decline of the general price level (measured by the Consumer Price Index – CPI) persisted in the fourth quarter of 2015, although at a smaller rate compared to the third quarter. 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.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the third quarter of 2015. Monthly indicators released by 15 January 2016 that contain information covering at most all the months in the final quarter of 2015 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 the fourth quarter of 2015 as well as for all the quarters of 2016 are shown in Table 1; projections for the whole of 2015 and 2016 are also provided. 1

- Based on the historical relationships between growth and numerous macroeconomic indicators, real GDP growth in 2015 is forecasted at 1.5% as the y–o–y increase of real economic activity in the fourth quarter of 2015 is estimated at 2.8%.

- Growth is expected to gain momentum in 2016 as real GDP is forecasted to expand by 2.7%. The y–o–y percentage change of GDP is projected at 2.7% and 2.4% for the first and second quarter respectively, and at 2.8% 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 0.6% for the last quarter of 2015 and of 0.7%, on average, for 2016.

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 forecast. Real economy factors (domestic and international activity and labour market) and components in the group which excludes real economy factors have a minor effect on

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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.
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the formation of the forecast in all quarters (about 1.3%).
However, real economy factors jointly with other economy aspects play a key role in determining the forecasts.

Table 1: GDP growth forecasts, forecast errors and contribution of components to forecasts

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<tr>
<th>COMPONENTS</th>
<th>2015</th>
<th>2016</th>
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<tr>
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<td>0.01</td>
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<tr>
<td>Excluding real economy</td>
<td>0.02</td>
<td>0.02</td>
</tr>
<tr>
<td>Real economy &amp; other aspects</td>
<td>2.79</td>
<td>2.63</td>
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<tr>
<td>Fiscal</td>
<td>0.22</td>
<td>0.20</td>
</tr>
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<td>Prices</td>
<td>0.50</td>
<td>0.43</td>
</tr>
<tr>
<td>Exchange rates</td>
<td>0.10</td>
<td>0.08</td>
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<tr>
<td>Interest rates, spreads</td>
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<td>0.67</td>
</tr>
<tr>
<td>Stock markets</td>
<td>0.46</td>
<td>0.44</td>
</tr>
<tr>
<td>Economic sentiment</td>
<td>0.59</td>
<td>0.63</td>
</tr>
<tr>
<td>Loans, deposits</td>
<td>0.20</td>
<td>0.18</td>
</tr>
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</table>

1 Table 1 is presented in the Appendix (Table A1) in greater detail by reporting the forecast resulting from each component together with the weight assigned to the component forecast for the computation of the final forecast.
2 For the first, second and third quarter of 2015 the y-o-y growth rates of GDP obtained from published data are used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 09/12/2015).
3 Pseudo out-of-sample root mean squared forecast error of the forecast method.
4 Differences between the forecasts and the sum of the components are due to rounding.

The forecasts in all quarters are mainly formed by models that include (one at a time) interest rates, spreads, economic sentiment indicators, domestic or foreign/international prices and stock market indices. Real economy factors and monthly leading values of series contained in the factors (e.g. unemployment rate, registered unemployed, arrivals of tourists, registrations of motor vehicles) are also included in the models. Historically such models have been generating more accurate forecasts than other groups of models and therefore have been gaining greater importance in the construction of the final 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 third quarter of 2015 and the unemployment rate declined slightly (to about 15%) over the same period. The decline (y-o-y) in the number of registered unemployed continued at a steady rate in the final quarter of 2015, 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) improved further during the fourth quarter of 2015.

- The reductions in domestic lending interest rates registered in 2015 amid conditions of weak demand and elevated unemployment are found to facilitate the economic recovery. Moreover, the significant slowdown in the contraction of domestic deposits in the third quarter together with the expansion registered in October ~ November, and the small positive growth rates in business loans impact positively on activity growth in the following quarters.

- Domestic economic confidence strengthened in 2015, despite some short-lived setback in the third quarter related to developments in Greece. More specifically, economic sentiment has been fluctuating above its long-run level throughout 2015, with a further upturn in all domestic sentiment indicators in the fourth quarter of 2015, leading to an improved outlook for 2016.

- Lower international oil prices, downward pressures to the domestic aggregate price level and low inflation in the EU are expected to benefit economic activity in Cyprus through their effects on real incomes and both domestic and external demand.

- Modest growth in the euro area and steady growth in the UK during the third quarter of 2015 as well as further increases in European economic sentiment indicators in the fourth quarter support the recovery in Cyprus by creating favourable foreign demand conditions.

- The weakening of the euro against key currencies, most notably the British pound, is expected to boost domestic activity in the following quarters through exports, particularly tourism services.

- Reductions in the European lending interest rates and in the borrowing costs of euro area governments during the second half of 2015 reflect ECB’s accommodative monetary policy stance which is supportive of the recovery process in Cyprus.

2 The group which excludes real economy factors includes: interest rates and spreads, stock market indicators, economic sentiment indicators, exchange rates, domestic and foreign price indices, international commodity prices, as well as fiscal and banking sector series.
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Nevertheless, the current record-low levels of European interest rates and the prolonged period of reduced interest rates in the euro area also reflect conditions of weak demand and uncertainties about the bloc’s growth momentum that have dampening effects on domestic growth. Similarly, the increased volatility in the international stock markets in 2015 (especially during the second half of the year) reflect risks about growth prospects in emerging markets and global growth that are found to affect somewhat the outlook due to the openness of the Cypriot economy.

On the domestic front, the unemployment rate that remains high by historical standards, the elevated public and private debt levels and the process of deleveraging as well as subdued new credit and deposit inflows weigh on growth.

There are both downside and upside risks to the outlook most of which have remained unchanged compared to the previous issue. Downside risks to the growth projections are discussed below.

- The high levels of non-performing loans 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 robust economic growth.

- Delays in the implementation of structural reforms agreed in the economic adjustment programme (e.g. public administration, privatisations, health system) may create risks to public finances, Cyprus’s market borrowing costs, especially after the end of the economic adjustment programme, and to activity.

- Deterioration of the external economic environment for Cyprus due to (i) the recession in Russia, (ii) weaker than expected growth in the euro area and the UK, as a result of a slowdown in emerging markets, especially in China, and (iii) heightened geopolitical tensions in eastern Mediterranean.

The IMF revised Russia’s growth forecasts for 2016 downwards, estimating a larger contraction in output than in its previous release [4]. For the euro area the IMF and the ECB are currently projecting moderate growth in 2016; for the UK the IMF is forecasting steady growth in 2016 [2], [4]. Nevertheless, the IMF has recently revised downwards the 2016 growth projections for both advanced and emerging economies [4].

Renewed recession in Greece may have limited negative effects on Cyprus due to the recent weakening of the connections between the banking systems of the two countries. The worsening of the Greek economic outlook alone is not expected to reverse the recovery in Cyprus.

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 efforts for the expansion and/or improvement of infrastructure could improve the medium-term prospects of the economy.

CPI inflation in 2016 is projected at 0.3%. The low inflation projection is driven by the lower international oil prices and by price declines in the international prices of non-energy commodities combined with sluggish domestic demand. Inflation is projected to pick up in the second half of the year as activity and demand will continue to firm up. 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 and a more prolonged period of lower international oil prices.

3. Concluding remarks

Quarterly data available up to the third quarter of 2015 and monthly indicators for the fourth quarter of 2015 released until 15 January 2016 are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

The forecast for real GDP growth for 2015 is revised from 1.3% in the October issue to 1.5%; the growth forecast for 2016 is revised from 1.5% to 2.7%. The upward revisions to the forecasts resulted from the higher than forecasted real GDP growth rate in the third quarter in Cyprus, modest growth rates in the EU as well as from further improvements registered in a number of domestic leading indicators during the final quarter of 2015.

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1. CPI inflation forecasts are constructed using a methodology similar to that for GDP growth forecasts (see footnote 1).
The forecast for CPI inflation in 2016 is revised upwards from -0.4% in the October issue to 0.3%. The upward revision resulted from a slower contraction of the general price level in the final quarter of 2015 compared to the third quarter of 2015 and from the pickup of domestic demand.

The forecasts for 2015 and 2016 presented in this issue suggest that real activity will continue to improve. The growth forecast for 2015 given here is in line with the projection of the Central Bank of Cyprus; it is, however, more optimistic than the forecast of the European Commission [1], [3]. Furthermore, the forecast for 2016 given in this bulletin points to faster growth than the rate projected by the Central Bank of Cyprus and the European Commission [1], [3]. The forecasts analysed in this bulletin are accompanied by upside and downside risks related to both external and domestic factors.

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

REFERENCES


APPENDIX

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

<table>
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