



Issue 17/1

# ECONOMIC OUTLOOK

## ECONOMICS RESEARCH CENTRE

January 2017

### SUMMARY

The expansion of real economic activity in Cyprus is expected to continue in 2017 at rates similar to those registered in 2016. Real GDP is forecasted to have increased by 2.9% in 2016. In 2017, real GDP is projected to grow by 3.1%.

The main drivers of the growth forecasts are given below.

- Robust GDP and employment growth continued in the third quarter of 2016 and many leading indicators with respect to domestic activity improved further during the final quarter of 2016.
- Moderate growth in the euro area and the EU, stronger-than-expected growth in the UK (in spite of the June 2016 Brexit vote) and the moderation of the recession in Russia.
- Further strengthening of economic sentiment in Cyprus and in the EU.
- Improved performance of foreign stock markets, reflecting less adverse external economic conditions now vis-à-vis the conditions in the first half of 2016.
- The prolonged period of declining energy prices and the subdued non-energy commodity prices.
- The ongoing normalisation of the domestic banking sector marked by increases in deposits, deleveraging and low lending interest rates.
- The improved general government balance and primary balance in January – November 2016, relative to the same period in 2015.

The low levels of European interest rates have been supportive of the recovery in Cyprus; however, the protracted period of low interest rates also reflects uncertainties about the growth momentum in the euro area which could weigh on the strength of the recovery in Cyprus in subsequent quarters.

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

- A considerable slowdown in the UK and further depreciation of the pound against the euro, as a result of increased political and economic uncertainty following the Brexit vote, are expected to directly affect the Cypriot economy, primarily through weaker exports of services.
- Weaker-than-expected growth in the EU and the euro area as a result of (i) the Brexit vote – impacting activity through e.g. trade and confidence channels – and (ii) worsening growth prospects in emerging market economies.
- The high private indebtedness levels that have led to deleveraging and increased default rates continue to pose significant risks to the stability of the domestic banking system and to the outlook for the economy, especially in conditions of subdued property prices.
- The high public debt-to-GDP ratio renders Cyprus vulnerable to external negative shocks; thus delays in the advancement of structural reforms may create risks to public finances, Cyprus's credibility and market borrowing costs.
- A protracted period of elevated unemployment could undermine the growth prospects of the Cypriot economy.

Upside risks to the outlook include (i) improved economic conditions in Russia as oil prices are rebounding, and (ii) new investment projects linked to tourism, energy and public infrastructure.

In 2017, inflation is projected to turn positive; CPI inflation is forecasted to reach 1.5% as activity growth is anticipated to continue and energy prices are expected to increase.



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#### 1. Recent developments

The Cypriot economy continued to grow strongly as real GDP increased by 2.9% year-on-year (y-o-y) in the third quarter of 2016 – at about the same rate as in the previous three quarters. In the third quarter, all sectors expanded (y-o-y) in terms of their real gross value added, except for information and communication activities, and financial and insurance services. The y-o-y contraction in financial and insurance services accelerated further in the third quarter. Over the same period, consumption registered robust growth driven by the increase in household expenditure; government consumption shrank (y-o-y) for the third consecutive quarter. Gross fixed capital formation contracted (y-o-y) in the third quarter of 2016 as a result of the decline in equipment investment; nevertheless, construction investment continued to rise. In the third quarter of 2016, exports grew (y-o-y) much faster than imports, leading to a positive contribution of net trade.

Many domestic leading indicators (e.g. credit card use by locals and tourists, registrations of motor vehicles, registrations of new companies, tourist arrivals, number of property sale contracts) continued to pick up in the final quarter of 2016. The Economic Sentiment Indicator (ESI) rose further during the fourth quarter due to improvements in consumer confidence and increases in business confidence in the sectors of retail trade and services. The decline in the number of registered unemployed continued in the fourth quarter of 2016, but at slower rates compared to previous quarters. The downward course in unemployment was reversed in the third quarter and the unemployment rate (Eurostat) increased further in October – November 2016.

During January – November 2016 the general government balance remained in surplus; public debt declined in September – November after it had peaked in August 2016.

Deposits registered strong growth between June and November 2016, driven by the inflows of domestic and European deposits. At the same time, the contraction in the stock of total loans accelerated as a result of deleveraging and subdued new credit. The small reduction in loans to domestic non-financial corporations first recorded in June 2016 continued throughout the third quarter and in October – November 2016; the stock of domestic housing loans has been falling but at smaller rates compared to the first half of 2016. Interest rates on loans to firms and households for house purchase are currently standing marginally below

their levels recorded in the first half of 2016. During the first 10 months of 2016 the stock of non-performing loans (local operations) was following a downward trend, while the proportion of restructured facilities to non-performing exposures was rising. Nevertheless, the high private indebtedness level continues to pose risks to the stability of the banking system and the economy at large.

In the final quarter of 2016, the contraction of the general price level (measured by the Consumer Price Index – CPI) accelerated vis-à-vis the third quarter; however, deflation eased in the second half of 2016. Negative inflation persisted in the fourth quarter mainly because of lower prices in the categories of transport, food and clothing-footwear.

#### 2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the third quarter of 2016. Monthly indicators released by 13 January 2017 that contain information covering all the months in the fourth quarter of 2016 at the most, 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 2016 as well as for all the quarters of 2017 are shown in Table 1; projections for the whole of 2016 and 2017 are also provided.<sup>1</sup>

- Based on the historical relationships between growth and numerous macroeconomic indicators, the expansion of real economic activity in Cyprus is estimated to continue in 2017 at rates similar to those registered in 2016. GDP is forecasted to have increased by 2.9% in 2016. GDP is projected to grow by 3.1% in 2017.
- The y-o-y percentage change in GDP in the fourth quarter of 2016 is projected at 2.9%; the quarter-on-quarter (q-o-q) percentage change in the final quarter is estimated at 0.7%.

<sup>1</sup> 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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- Robust growth is forecasted to continue in 2017; real GDP is projected to rise by 3.2% and 3.0% in the first and second half of the year, respectively. The q-o-q percentage changes in real GDP in the first and second half of 2017 are estimated on average at 0.8% and 0.6%, respectively.

**Table 1: GDP growth forecasts, forecast errors and contribution of components to forecasts<sup>1</sup>**

YEAR	2016		2017		
<b>FORECAST<sup>2</sup></b>	<b>2.9</b>		<b>3.1</b>		
QUARTER	4	1	2	3	4
<b>FORECAST (y-o-y)</b>	<b>2.9</b>	<b>3.2</b>	<b>3.1</b>	<b>3.1</b>	<b>2.9</b>
Forecast error <sup>3</sup>	0.7	1.3	2.1	3.0	3.4
<b>COMPONENTS<sup>4</sup></b>					
<b>Real economy</b>	<b>0.02</b>	<b>0.02</b>	<b>0.01</b>	<b>0.01</b>	<b>0.01</b>
<b>Excluding real economy</b>	<b>0.04</b>	<b>0.04</b>	<b>0.04</b>	<b>0.04</b>	<b>0.04</b>
<b>Real economy &amp; other aspects</b>	<b>2.84</b>	<b>3.16</b>	<b>3.03</b>	<b>3.06</b>	<b>2.86</b>
Fiscal	0.21	0.22	0.20	0.19	0.18
Prices	0.45	0.51	0.49	0.48	0.47
Exchange rates	0.09	0.09	0.07	0.08	0.08
Interest rates, spreads	0.68	0.82	0.78	0.74	0.72
Stock markets	0.54	0.58	0.56	0.60	0.54
Economic sentiment	0.67	0.68	0.68	0.65	0.56
Loans, deposits	0.20	0.26	0.25	0.32	0.32

<sup>1</sup> 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.

<sup>2</sup> For the first, second and third quarter of 2016 the y-o-y growth rates of GDP obtained from published data are used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 09/12/2016).

<sup>3</sup> Pseudo out-of-sample root mean squared forecast error of the forecast method.

<sup>4</sup> Differences between the forecasts and the sum of the components are due to rounding.

Table 1 also presents 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

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 1.8%).<sup>2</sup> However, *real economy factors jointly with other economy aspects* play a key role in determining the forecasts.

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 growth forecasts are discussed below.

- The Cypriot economy posted robust GDP and employment growth in the third quarter of 2016, continuing the strong performance registered in the first half of 2016. Many leading indicators with respect to domestic activity (e.g. credit card use, registrations of motor vehicles, property sale contracts, registrations of new companies) picked up further during October – December 2016. The number of registered unemployed continued to fall, but at a slower pace relative to the previous three quarters.
- Growth in the euro area and the EU remained moderate in the third quarter and unemployment in the euro area subsided further in October – November. In the UK, the outturn in the third quarter was stronger than expected, in spite of the June 2016 Brexit vote. In Russia, the recession has been easing since the first quarter of 2016.
- Economic sentiment in Cyprus and in the EU strengthened further in the final quarter of 2016, indicating favourable economic conditions in the following quarters.

<sup>2</sup> 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 (loans, deposits).

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- The performance of foreign stock markets improved in the third quarter of 2016 and picked up further in the final quarter, reflecting less adverse external economic conditions now vis-à-vis the conditions in the first half of 2016, and therefore better growth prospects.
- In spite of the recent increases in international oil prices, the prolonged period of declining energy prices and the subdued non-energy commodity prices will continue to support domestic economic activity in the next quarters.
- The ongoing normalisation of the domestic banking sector marked by deposit growth, deleveraging and low lending interest rates is projected to have positive effects on growth.
- The improved general government balance and primary balance in January – November 2016, relative to the same period in 2015, contribute to the recovery.

The low levels of European interest rates (reflecting the accommodative monetary policy stance), have been supportive of the recovery in Cyprus as described in previous issues. However, the protracted period of low interest rates in the euro area is found to weigh on the strength of the recovery in Cyprus as it reflects uncertainties about the bloc's growth momentum. Moreover, the depreciation of the British pound against the euro, as a result of the Brexit vote and the ensuing uncertainty in the UK, could also weigh on the growth prospects in Cyprus.

There are both downside and upside risks to the outlook. Downside risks to the growth projections relating to the external environment are discussed below.

- A considerable slowdown in the UK and further depreciation of the pound against the euro, as a result of increased political and economic uncertainty following the Brexit vote, are expected to directly affect the Cypriot economy, primarily through weaker exports of services.
- Weaker-than-expected growth in the EU and the euro area as a result of (i) the Brexit vote – impacting activity through e.g. trade and confidence channels – and (ii) worsening growth prospects in emerging market economies.

The downside risks stemming from domestic weaknesses relate to the following:

- The high private indebtedness levels that have led to deleveraging and increased default rates continue to pose significant risks to the stability of the domestic

banking system and growth, especially in conditions of subdued property prices.

- The high public debt-to-GDP ratio renders Cyprus vulnerable to external negative shocks; thus delays in the advancement of structural reforms may create risks to public finances, Cyprus's credibility and market borrowing costs.
- A protracted period of high unemployment could undermine the growth prospects of the Cypriot economy.

As in the previous issue, upside risks to the outlook relate to external and domestic factors. Improved economic conditions in Russia as oil prices and the rouble are rebounding, are expected to have positive effects on domestic activity. On the domestic front, investment decisions linked mainly to tourism and energy, as well as new public investment projects could boost the economy's prospects.

In 2017, inflation is projected to turn positive; CPI inflation is forecasted to reach 1.5% as activity growth is anticipated to continue and energy prices are expected to rise.<sup>3</sup> The projected increase in inflation in 2017 also reflects base effects due to the relatively low general price level in 2016.

Upside risks to the forecasts relate to faster increases in international commodity prices, particularly oil, stronger demand, and the weakening of the euro against the US dollar. Downside risks to the projections are associated with weaker than expected demand and renewed downward pressures in international energy prices.

### 3. Concluding remarks

Quarterly data available up to the third quarter of 2016, and monthly indicators for the final quarter of 2016 released until 13 January 2017, are employed in dynamic econometric models to construct forecasts for growth and inflation.

The forecast for real GDP growth in 2016 has remained unchanged at 2.9% – as in the October issue. The projection for 2017 has been revised down slightly to 3.1% from 3.2% in the October issue. The downward revision resulted mainly from the marginally lower-than-forecasted growth rate in the third quarter and the reversal in the downward trend in unemployment during the second half of 2016.

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

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The CPI inflation projection for 2017 is revised to 1.5% from 1.9% in the previous issue. The downward revision resulted from the acceleration of deflation in the final quarter of 2016.

The forecasts presented in this issue suggest that real activity will continue to improve in the following quarters. The growth forecast for 2017 presented here is slightly more optimistic than the growth rate projected by the Central Bank of Cyprus (2.8%) and the European Commission (2.5%) [1], [2]. The forecasts analysed in this bulletin are accompanied by upside and downside risks associated with domestic and external factors.

#### REFERENCES

1. Central Bank of Cyprus (2016), "Economic Bulletin – December 2016", Nicosia – Cyprus (in Greek).
2. European Commission, "European Economic Forecast: Autumn 2016", European Economy Institutional Paper 038, November 2016.

#### APPENDIX

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

YEAR	CONTRIBUTION BY COMPONENT					WEIGHT					FORECAST BY COMPONENT				
	2016	2017				2016	2017				2016	2017			
QUARTER	4	1	2	3	4	4	1	2	3	4	4	1	2	3	4
COMPONENTS															
Real economy	0.02	0.02	0.01	0.01	0.01	0.62	0.53	0.51	0.53	0.50	2.8	3.1	2.8	2.8	2.7
Excluding real economy	0.04	0.04	0.04	0.04	0.04	1.28	1.25	1.21	1.40	1.30	3.0	3.3	3.2	3.1	3.0
Real economy & other aspects	2.84	3.16	3.03	3.06	2.86	98.11	98.21	98.28	98.07	98.20	2.9	3.2	3.1	3.1	2.9
Fiscal	0.21	0.22	0.20	0.19	0.18	7.43	7.19	6.56	6.95	6.89	2.8	3.1	3.0	2.8	2.7
Prices	0.45	0.51	0.49	0.48	0.47	15.86	15.93	16.16	15.87	15.59	2.9	3.2	3.0	3.0	3.0
Exchange rates	0.09	0.09	0.07	0.08	0.08	3.29	2.79	2.73	2.92	3.06	2.7	3.1	2.7	2.6	2.5
Interest rates, spreads	0.68	0.82	0.78	0.74	0.72	24.37	26.81	27.62	28.31	31.72	2.8	3.0	2.8	2.6	2.3
Stock markets	0.54	0.58	0.56	0.60	0.54	18.24	17.98	17.50	18.32	17.28	2.9	3.2	3.2	3.3	3.1
Economic sentiment	0.67	0.68	0.68	0.65	0.56	22.35	20.31	20.95	18.96	16.91	3.0	3.4	3.2	3.4	3.3
Loans, deposits	0.20	0.26	0.25	0.32	0.32	6.58	7.20	6.75	6.74	6.76	3.0	3.6	3.7	4.7	4.7
<b>FORECAST</b>	<b>2.9</b>	<b>3.2</b>	<b>3.1</b>	<b>3.1</b>	<b>2.9</b>										



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# **ECONOMIC OUTLOOK**

## **ECONOMICS RESEARCH CENTRE**

**January 2017**

The Economics Research Centre (CypERC) of the University of Cyprus is an independent, non-profit organization with the aim of promoting scientific knowledge in economics, especially in matters concerning Cyprus.

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