



Issue 17/2

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

May 2017

SUMMARY

The expansion of real economic activity in Cyprus is expected to continue in 2017 at slightly faster rates vis-à-vis those registered in 2016. In 2017, real GDP is projected to grow by 3.1%. In the first quarter of 2017, real GDP is projected to rise (year-on-year) by 3.5% and in the second quarter GDP growth is forecasted at 3.1%. In the second half of 2017, real activity is forecasted to grow by 3.0% (year-on-year).

The contributing factors in the strong growth rates forecasted are given below.

- Solid activity and employment growth in Cyprus in 2016 and positive developments in many domestic leading indicators in the first quarter of 2017, including further strengthening of domestic economic sentiment.
- Less adverse domestic financial conditions as the normalisation process of the domestic banking sector has progressed (e.g. deposit growth, deleveraging) and lending interest rates have declined further.
- Other domestic factors, such as the strong fiscal performance and past declines in the domestic price level.
- Favourable external economic conditions, such as moderate activity growth in the EU and the euro area, stronger-than-expected growth in the UK after the Brexit vote, the moderation of the recession in Russia and rising economic sentiment in the EU and the euro area.
- Other external factors, such as the low levels of European interest rates and the improved performance of foreign stock markets in recent quarters.

Downside risks to the growth forecasts are discussed below.

- In conditions of elevated unemployment and subdued property prices, the high levels of private debt and non-performing loans continue to pose risks to the economy, despite progress with deleveraging and loan restructurings. Ineffective implementation of the available legal tools heightens the risks arising from the banking sector.
- The high public debt-to-GDP ratio renders Cyprus vulnerable to negative shocks. Stalling structural reforms and relaxing fiscal discipline, especially in view of the upcoming elections, may undermine the sustainability of public finances and growth.
- Slower-than-expected growth in the UK and further depreciation of the pound against the euro, as a result of increased uncertainty following the Brexit vote, could adversely affect the outlook for the Cypriot economy.

Upside risks to the outlook relate to the economic recovery in Russia as oil prices and the rouble are rebounding. Moreover, public infrastructure projects and private investment decisions (related to e.g. energy, tourism, shipping, real estate) could boost the economy's prospects. The geopolitical situation in the Eastern Mediterranean involves both downside and upside risks to the outlook that may affect domestic activity primarily through tourism.

In 2017, CPI inflation is forecasted to reach 1.7% as activity continues to expand and international oil and food prices continue to rebound. The projected inflation rate in 2017 also reflects base effects due to the relatively low general price level registered in 2016.





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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 final quarter of 2016. Growth accelerated as real activity expanded by 2.8% in 2016 compared with 1.7% in 2015.

In the fourth quarter of 2016, 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. Over the same period, private consumption increased robustly, while government consumption shrank (y-o-y). Gross fixed capital formation surged in the fourth quarter of 2016 as a result of a sharp increase in transport equipment (due to ship registrations) that also led to a large rise in imports. Also, construction investment grew strongly whereas exports rose marginally in the final quarter of 2016.

Many domestic leading indicators (e.g. credit card use by locals and tourists, registrations of motor vehicles, registrations of new companies, tourist arrivals, cement sales, number of property sale contracts, the Cyprus stock exchange index) continued to pick up during the first quarter of 2017. The Economic Sentiment Indicator (ESI) rose further in the first quarter as a result of stronger business confidence in services, industry and construction. The decline in the number of registered unemployed continued, accelerating in February – March 2017 vis-à-vis January 2017 and December 2016. In 2016, unemployment remained elevated at about 13%; recent data show that the unemployment rate (Eurostat) declined slightly in the first quarter of 2017.

The strong fiscal performance registered in 2016 continued in January – February 2017 as the general government balance remained in surplus; nevertheless there are no clear indications of a downward trend in public debt.

The increase in deposits speeded up in the final quarter of 2016 and remained robust in the first quarter of 2017; the increase was driven by inflows of domestic and European deposits. The decline in the stock of total loans continued in the final quarter of 2016 as a result of deleveraging and subdued new credit; the contraction decelerated during the first quarter of the year, particularly in the case of domestic loans. Further reductions in lending interest rates were registered in January – February 2017. Throughout 2016, non-performing loans (local operations) were declining and

restructured facilities as a percentage of non-performing exposures were rising.

After four years of negative inflation, the general price level (measured by the Consumer Price Index – CPI) increased by 1.4% in the first quarter of 2017, mainly because of price increases in the categories of food, energy and transport.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the fourth quarter of 2016. Monthly indicators released by 19 April 2017 that contain information covering all the months in the first quarter of 2017 at the most, are also used. All forecasts presented in this bulletin are based solely on published data; thus, they only incorporate effects 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 2017 are shown in Table 1; the projection for the whole of 2017 is also provided.¹

- Based on the historical relationships between growth and numerous macroeconomic indicators, the expansion of real economic activity in Cyprus is estimated to slightly accelerate in 2017. GDP is projected to grow by 3.1% in 2017.
- Real GDP is projected to rise by 3.5% in the first quarter and 3.1% in the second quarter of the year; real activity is forecasted to grow by 3.0% in the second half of 2017.
- The q-o-q percentage changes in real GDP for the first two quarters of 2017 are estimated at 0.8%; the q-o-q growth rate in the second half of the year is projected at 0.6% on average.

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

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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which *excludes real economy* factors, have a minor effect on the formation of the forecast in all quarters (about 1.7%).² 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 forecasts¹

YEAR	2017			
FORECAST	3.1			
QUARTER	1	2	3	4
FORECAST (y-o-y)	3.5	3.1	3.1	2.9
Forecast error ²	0.7	1.2	2.0	2.9
COMPONENTS³				
Real economy	0.02	0.02	0.02	0.01
Excluding real economy	0.04	0.03	0.03	0.03
Real economy & other aspects	3.40	3.03	3.08	2.86
Fiscal	0.32	0.25	0.22	0.22
Prices	0.59	0.48	0.48	0.48
Exchange rates	0.13	0.09	0.08	0.08
Interest rates, spreads	0.80	0.79	0.81	0.66
Stock markets	0.59	0.58	0.59	0.58
Economic sentiment	0.69	0.59	0.66	0.60
Loans, deposits	0.28	0.24	0.24	0.24

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 Pseudo out-of-sample root mean squared forecast error of the forecast method.

³ Differences between the forecasts and the sum of the components are due to rounding.

The forecasts for 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

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 (loans, deposits).

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 projection for 2017 and the main drivers of the forecast have remained unchanged vis-à-vis the January issue. The contributing factors in the strong growth rates forecasted are given below.

- *Solid activity and employment growth in Cyprus.* Real GDP and employment have been expanding vigorously throughout 2016. The developments in many domestic leading indicators in recent months, suggest that the strong performance of the Cypriot economy has continued in the first quarter of 2017.
- *Further improvements in domestic economic sentiment.* Business and consumer confidence indicators rose further in the final quarter of 2016 and in the first quarter of 2017, indicating a continuation of the favourable economic conditions.
- *Less adverse domestic financial conditions.* Further progress in the normalisation process in the domestic banking sector (marked by e.g. deposit growth and deleveraging) and low lending interest rates support growth.
- *Other domestic factors.* The strong fiscal performance (marked by increases in government revenues and positive budget balances) and past declines in prices support the recovery.
- *Favourable external economic conditions.* In 2016, activity in the EU and the euro area expanded moderately, growth in the UK was stronger than expected after the June 2016 Brexit vote, and the recession in Russia moderated. Moreover, the economic sentiment in the EU and the euro area has been strengthening since the third quarter of 2016.
- *Improved performance of foreign stock markets.* The positive developments in foreign stock prices after the first half of 2016, which reflect, inter alia, improved global growth prospects, contribute towards solid growth in Cyprus in the following quarters.
- *Low levels of European interest rates.* In spite of the recent increases in long-term government interest rates in the



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euro area, European interest rates have remained at low levels (reflecting the accommodative monetary policy stance) with positive effects on the recovery in Cyprus. However, their positive effects on projected growth weaken towards the end of the forecast horizon.

There are both downside and upside risks to the outlook. The downside risks to the projections are discussed below.

- In conditions of elevated unemployment and subdued property prices, the high levels of private debt and non-performing loans continue to pose risks to the economy, despite progress with deleveraging and loan restructurings. Ineffective implementation of the available legal tools heightens the risks arising from the banking sector.
- The high public debt-to-GDP ratio renders Cyprus vulnerable to negative shocks. Stalling structural reforms and relaxing fiscal discipline, especially in view of the upcoming elections, may undermine the sustainability of public finances and growth.
- Slower-than-expected growth in the UK and further depreciation of the pound against the euro, as a result of increased uncertainty following the Brexit vote, could negatively affect the outlook for the Cypriot economy.

Upside risks to the outlook relate to the economic recovery in Russia as oil prices and the rouble are rebounding. Moreover, public infrastructure projects and private investment decisions (related to e.g. tourism, energy, shipping, real estate) could boost the economy's prospects. The geopolitical situation in the Eastern Mediterranean involves both downside and upside risks to the outlook that may affect domestic activity primarily through tourism.

In 2017, CPI inflation is forecasted to reach 1.7% as activity continues to expand and international oil and food prices continue to rebound.³ The projected inflation rate in 2017 also reflects base effects due to the relatively low general price level registered in 2016. Upside risks to the forecast 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 projection are associated with weaker than expected demand.

3. Concluding remarks

Quarterly data available up to the fourth quarter of 2016, and monthly indicators for the first quarter of 2017 released until 19 April 2017, are employed in dynamic econometric models to construct forecasts for growth and inflation.

The forecast for real GDP growth in 2017 has remained unchanged at 3.1% as in the January issue. The CPI inflation projection for 2017 is revised to 1.7% from 1.5% in the previous issue. The upward revision resulted mainly from positive inflation in the first quarter of the year and increases in international oil and non-energy prices.

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 more optimistic than the growth rate projected by the European Commission and the IMF (2.5%), but it is quite close to projection provided by the Ministry of Finance (2.9%) in the Stability Programme 2017 – 2020 [1] – [3]. Preliminary results show that solid growth is expected to continue in 2018.

REFERENCES

1. European Commission, "European Economic Forecast: Winter 2017", European Economy Institutional Paper 048, February 2017.
2. Ministry of Finance, "Stability Programme 2017 – 2020", April 2017.
3. International Monetary Fund (IMF), "World Economic Outlook: Gaining Momentum?", Washington, April 2017.

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

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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			
	2017				2017				2017			
QUARTER	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
Real economy	0.02	0.02	0.02	0.01	0.64	0.53	0.52	0.51	3.4	3.0	3.0	2.9
Excluding real economy	0.04	0.03	0.03	0.03	1.08	1.13	1.15	1.21	3.3	3.0	2.9	2.7
Real economy & other aspects	3.40	3.03	3.08	2.86	98.28	98.34	98.34	98.28	3.5	3.1	3.1	2.9
Fiscal	0.32	0.25	0.22	0.22	8.92	7.98	6.82	6.74	3.6	3.2	3.2	3.3
Prices	0.59	0.48	0.48	0.48	17.19	15.64	14.99	14.73	3.4	3.1	3.2	3.3
Exchange rates	0.13	0.09	0.08	0.08	3.62	3.02	2.76	2.74	3.5	3.0	3.1	2.8
Interest rates, spreads	0.80	0.79	0.81	0.66	23.48	26.85	29.14	31.24	3.4	2.9	2.8	2.1
Stock markets	0.59	0.58	0.59	0.58	16.94	18.18	17.42	17.30	3.5	3.2	3.4	3.3
Economic sentiment	0.69	0.59	0.66	0.60	20.04	19.21	20.37	19.04	3.5	3.1	3.2	3.2
Loans, deposits	0.28	0.24	0.24	0.24	8.10	7.45	6.83	6.48	3.5	3.2	3.5	3.7
FORECAST	3.5	3.1	3.1	2.9	100	100	100	100	-	-	-	-



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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.

Director: Prof. Elena Andreou

Senior Academic Advisor: Prof. Emeritus Panos Pashardes

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Sector of Macroeconomic Forecasts and Analysis

Research Coordinator: Nicoletta Pashourtidou

Research Officers: Christos Papamichael, Charalampos Karagiannakis

Academic Advisor: Assoc. Prof. Andros Kourtellos

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Economics Research Centre, University of Cyprus, P.O. box 20537, 1678 Nicosia, CYPRUS
Telephone: 22893660, Fax: 22895027, Website: www.erc.ucy.ac.cy, Email: erc@ucy.ac.cy