



Issue 17/4

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

November 2017

Summary

Real economic activity in Cyprus is expected to continue to expand strongly in 2017 and 2018. In 2017, real GDP is projected to grow by 3.6%. In the third quarter of 2017, real GDP is forecasted to rise (year-on-year) by 3.6% and in the final quarter of the year, GDP growth is estimated at 3.7%. In 2018, real GDP growth is forecasted to remain robust at 3.3%.

The factors driving the solid growth rates forecasted for the following quarters include: the robust activity and employment growth rates registered in Cyprus in the first half of 2017, further improvements in domestic leading indicators in the third quarter of the year, strong domestic economic sentiment, restored confidence in the financial sector, the low levels of lending interest rates and favourable external economic conditions.

Downside risks to the growth forecasts that are associated with domestic weaknesses include: the high levels of private debt and non-performing exposures, the high ratio of public debt to GDP, incomplete structural reforms and the introduction of permanent expenditures with unclear longer-term budget effects. Downside risks stemming from the external economic environment relate to slower-than-expected growth in the UK and further depreciation of the pound against the euro. Upside risks to the outlook are associated with public investment in infrastructure and private investment, especially in the sectors of energy, tourism and real estate, as well as with better-than-anticipated growth outturn in the euro area and Russia.

The more optimistic outlook in this bulletin, vis-a-vis the July issue, is mainly the result of a large upward revision to the GDP growth data for first quarter of 2017. The positive developments in domestic macroeconomic and leading indicators, and the favourable external economic conditions have also contributed to the upward revisions of the growth forecasts.

Νοέμβριος 2017

Περίληψη

Η πραγματική οικονομική δραστηριότητα στην Κύπρο αναμένεται ότι θα συνεχίσει να αυξάνεται με ισχυρούς ρυθμούς κατά το 2017 και 2018. Το 2017, το ΑΕΠ (σε σταθερές τιμές) προβλέπεται να αυξηθεί κατά 3,6%. Το τρίτο και το τέταρτο τρίμηνο του 2017, το πραγματικό ΑΕΠ εκτιμάται ότι θα αυξηθεί κατά 3,6% και 3,7% συγκριτικά με τα αντίστοιχα τρίμηνα του 2016. Οι ικανοποιητικοί ρυθμοί ανάπτυξης του ΑΕΠ εκτιμάται ότι θα συνεχίσουν και κατά το 2018, με την πρόβλεψη για το έτος να διαμορφώνεται στο 3,3%.

Παράγοντες που συμβάλλουν στην προβλεπόμενη άνοδο του ΑΕΠ περιλαμβάνουν: τους ικανοποιητικούς ρυθμούς αύξησης της δραστηριότητας και απασχόλησης στην Κύπρο το πρώτο εξάμηνο του 2017, περαιτέρω θετικές εξελίξεις σε εγχώριους προπορευόμενους δείκτες κατά το τρίτο τρίμηνο του 2017, τα ψηλά επίπεδα οικονομικής εμπιστοσύνης, τα χαμηλά επίπεδα δανειστικών επιτοκίων, την αποκατάσταση της εμπιστοσύνης στο εγχώριο χρηματοπιστωτικό σύστημα και το ευνοϊκό εξωτερικό οικονομικό περιβάλλον.

Κίνδυνοι για χαμηλότερη από την προβλεπόμενη ανάπτυξη περιλαμβάνουν: τα ψηλά επίπεδα ιδιωτικού χρέους και μη εξυπηρετούμενων χορηγήσεων, το ψηλό ποσοστό του δημόσιου χρέους ως προς το ΑΕΠ, ατελείς διαρθρωτικές μεταρρυθμίσεις και την εισαγωγή μόνιμων δημοσίων δαπανών με αβέβαιες μέσο/μακροπρόθεσμες δημοσιονομικές επιπτώσεις. Κίνδυνοι που πηγάζουν από το εξωτερικό περιβάλλον σχετίζονται με χαμηλότερους ρυθμούς ανάπτυξης από τους αναμενόμενους στο Ηνωμένο Βασίλειο και περαιτέρω υποτίμηση της στερλίνιας έναντι του ευρώ. Παράγοντες για καλύτερες οικονομικές προοπτικές από τις προβλεπόμενες σχετίζονται με δημόσιες επενδύσεις σε υποδομές και ιδιωτικές επενδύσεις, κυρίως στους τομείς της ενέργειας, του τουρισμού και των κτηματομεσιτικών, καθώς και με καλύτερη οικονομική επίδοση από την αναμενόμενη στην ευρωζώνη και στη Ρωσία.

Οι προοπτικές για την κυπριακή οικονομία που παρουσιάζονται σε αυτό το δελτίο είναι πιο αισιόδοξες συγκριτικά με αυτές στο τεύχος Ιουλίου, κυρίως λόγω της μεγάλης προς τα πάνω αναθεώρησης των στοιχείων για το ρυθμό μεταβολής του ΑΕΠ του πρώτου τριμήνου 2017. Οι θετικές εξελίξεις σε μακροοικονομικούς και προπορευόμενους δείκτες κατά το δεύτερο και τρίτο τρίμηνο του έτους, καθώς και το ευνοϊκό εξωτερικό οικονομικό περιβάλλον έχουν, επίσης, συμβάλει στην προς τα πάνω αναθεώρηση των προβλέψεων για το 2017 και 2018.

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1. Recent developments

The Cypriot economy posted robust growth in the second quarter of 2017 as real GDP increased by 3.5%, year-on-year (y-o-y), slightly below the growth rate of 3.7% registered in first quarter. In the second quarter of 2017, all sectors expanded (y-o-y) in terms of their real gross value added, except for financial and insurance services, which have been contracting since the first quarter of 2016. Private and government consumption picked up further in the second quarter, while gross capital formation contracted as a result of declines in investment in transport equipment and inventories. Machinery and construction investment as well as net exports contributed positively to growth in the second quarter.

Many domestic leading indicators (e.g. credit card use, retail trade volume index, tourist arrivals, registrations of motor vehicles, number of property sale contracts) continued to increase during the third quarter of 2017. In the third quarter, the Economic Sentiment Indicator (ESI) declined as a result of weaker confidence in services; nevertheless, the overall economic sentiment in Cyprus and confidence in services in particular remain at historically high levels.

The decline in the number of registered unemployed accelerated further in the third quarter of 2017. In the second quarter of the year, the unemployment rate (Eurostat) fell to about 11%; in July and August 2017 unemployment stood just below 11%.

Over the period January – August 2017, government revenue has increased much faster than expenditure, resulting in a strong budget performance. Public debt has remained above 100% of GDP, although the long-term interest rate on government bonds has declined further.

Deposits held in Cyprus by domestic and other euro area residents have been rising throughout the period January – August 2017, while the stock of loans has been contracting over the same period, as a result of deleveraging and subdued new credit. Interest rates remain low by historical standards, but the high level of non-performing exposures relative to the size of the economy, continues to pose challenges to financial and macroeconomic soundness.

Inflation (measured by the Consumer Price Index – CPI) turned negative in the third quarter at -0.4% compared with 1.2% in the second quarter of 2017. The negative inflation in the third quarter was mainly driven by price declines in the

categories of food, household equipment, communication and miscellaneous goods and services.

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the second quarter of 2017. Monthly indicators released by 12 October 2017 that contain information covering all the months in the third 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 the third and final quarters of 2017 and all the quarters of 2018 are shown in Table 1; the projections for the whole of 2017 and 2018 are 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 continue at robust rates in 2017 and 2018. Real GDP growth is estimated at 3.6% in 2017. In 2018, growth is forecasted at 3.3%.
- In the second half of 2017, real activity growth is projected to remain strong; real GDP is forecasted to increase by 3.6% and 3.7% (y-o-y) in the third and fourth quarters of the year, respectively.
- Growth is estimated to continue at solid rates in 2018. Real GDP growth is projected to reach 3.5% in the first half of 2018 and subsequently to ease to 3.2% in the second half of 2018.

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

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 forecasts in all quarters (about 1.4%).² However, *real economy factors jointly with other aspects* play a key role in determining the forecasts.

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

YEAR	2017			
FORECAST ²	3.6			
Quarter	3	4		
FORECAST (y-o-y)	3.6	3.7		
Forecast error ³	0.7	1.2		
COMPONENTS ⁴				
Real economy	0.02	0.02		
Excluding real economy	0.04	0.04		
Real economy & other aspects	3.55	3.69		
Fiscal	0.28	0.30		
Prices	0.57	0.54		
Exchange rates	0.13	0.11		
Interest rates, spreads	0.90	1.00		
Stock markets	0.63	0.69		
Economic sentiment	0.78	0.81		
Loans, deposits	0.27	0.24		
YEAR	2018			
FORECAST	3.3			
Quarter	1	2	3	4
FORECAST (y-o-y)	3.6	3.4	3.3	3.0
Forecast error ³	1.9	2.8	3.2	3.7
COMPONENTS ⁴				
Real economy	0.02	0.02	0.01	0.01
Excluding real economy	0.03	0.03	0.03	0.02
Real economy & other aspects	3.52	3.37	3.22	3.01
Fiscal	0.25	0.23	0.24	0.23
Prices	0.50	0.50	0.52	0.49
Exchange rates	0.10	0.09	0.09	0.10
Interest rates, spreads	0.99	0.90	0.89	0.92
Stock markets	0.66	0.64	0.59	0.51
Economic sentiment	0.78	0.75	0.60	0.51
Loans, deposits	0.25	0.26	0.29	0.27

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 and second quarters of 2017 the y-o-y growth rates of GDP obtained from published data are used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 08/09/2017).

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.

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).

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.³ 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.

The growth forecasts for 2017 and 2018 are driven by domestic and external factors discussed below:

- *Robust activity and employment growth in Cyprus.* The growth rate of real GDP and employment remained strong in the second quarter of 2017. Domestic leading indicators suggest that labour market conditions and economic activity continued to improve in the third quarter of 2017.
- *Improving domestic financial conditions.* Growth is supported by increasing deposits, ongoing deleveraging and declining non-performing exposures as well as by the low levels of lending interest rates and the pickup of the Cyprus stock market.
- *Strong domestic economic sentiment.* In spite of a recent decline in economic sentiment, confidence, especially in services and among consumers, has reached high levels, fuelling activity growth in the following quarters.
- *Favourable external economic conditions.* In the second quarter of 2017, growth in the EU and the euro area accelerated, the recovery of the Russian economy strengthened and the UK economy continued to expand, albeit at a slower rate compared with the first quarter. Moreover, in the second and third quarters of 2017, economic sentiment in the EU and the euro area picked up further and the performance of international stock markets remained positive, reflecting a favourable external economic environment.

Other factors, such as the strong fiscal performance and the the absence of significant upward pressures to the general price level are found to contribute to the solid growth rates forecasted for the following quarters.

³ Economic sentiment indicators refer to data obtained through the Harmonised Business and Consumer Surveys Programme conducted by the Directorate General for Economic and Financial Affairs. The Economics Research Centre acknowledges funding from the European Commission and the Ministry of Finance for conducting the Business and Consumer Survey Project in Cyprus.

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The prolonged period of low European interest rates (reflecting the accommodative monetary policy stance) and the narrowing of sovereign spreads in the euro area have supported the recovery in Cyprus as discussed in previous issues. Nevertheless, as growth gains momentum, the beneficial effects of these factors on the outlook become less pronounced.

The risks to the outlook have remained unchanged compared to the July issue. Downside risks to the projections stem from domestic weaknesses and external factors:

- The high levels of private debt and non-performing exposures continue to pose risks to the economy, despite progress with deleveraging and managing problematic loans. The large volume of problematic assets on banks' balance sheets and the high indebtedness levels deprive the economy of growth-enhancing investment.
- The high ratio of public debt to GDP renders Cyprus vulnerable to negative shocks. Incomplete structural reforms and the introduction of permanent expenditures with unclear longer-term budget effects, may undermine investor confidence and the sustainability of public finances.
- Slower-than-expected growth in the UK and further depreciation of the pound against the euro, as a result of uncertainty regarding the post-Brexit relations between the UK and the EU, could negatively affect the outlook for the Cypriot economy.

Upside risks to the outlook are associated with public investment in infrastructure and private investment, especially in the sectors of energy, tourism and real estate. Moreover, better-than-anticipated growth outturn in the euro area, stronger-than-expected economic recovery in Russia and the rebound of the rouble may lead to faster growth rates than the current forecasts.

In 2017, CPI inflation is forecasted to remain subdued at 0.7% and in 2018, inflation is projected to pick up to 1.8%, as activity continues to expand and international oil prices recover slowly.⁴ Upside risks to the forecasts relate to stronger demand and faster wage growth, more rapid increases in international commodity prices and the weakening of the euro against the US dollar. Downside risks

to the projections are associated with a demand shortfall and a slower rebound of international commodity prices, particularly oil prices.

3. Concluding remarks

Quarterly data available up to the second quarter of 2017, and monthly indicators available up to the third quarter of the year and released until 12 October 2017, are employed in dynamic econometric models to construct forecasts for growth and inflation.

The forecast for real GDP growth in 2017 has been revised from 3.0% in the July issue to 3.6%. The forecast for 2018 has been revised from 2.7% in the previous issue to 3.3%. The more optimistic outlook in this issue is mainly the result of a large upward revision to the GDP growth data for the first quarter of 2017. The positive developments in domestic macroeconomic and leading indicators, and the favourable external economic conditions have also contributed to the upward revisions of the forecasts.

The CPI inflation projection for 2017 has been revised from 1.3% in the previous issue to 0.7%; the inflation forecast for 2018 has been revised from 1.9% to 1.8%. The downward revisions to the forecasts were driven by the negative inflation rate registered in the third quarter as well as by the absence of strong increases in international commodity prices in the last two quarters.

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 similar to the growth rate projected by the Ministry of Finance (3.6%) and the IMF (3.4%) [1], [2]. For 2018, the growth forecast in this bulletin is more optimistic than the growth rate forecasted by the Ministry of Finance (3.0%) and the IMF (2.6%) [1], [2].

REFERENCES

1. International Monetary Fund (IMF), "World Economic Outlook: Seeking Sustainable Growth—Short-term Recovery, Long-term Challenges", Washington, October 2017.
2. Ministry of Finance, "Economic Developments 2017 and Prospects 2018–2020", October 2017 (in Greek).

⁴ 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 forecasts by component

CONTRIBUTION BY COMPONENT					WEIGHT				FORECAST BY COMPONENT			
Year	2017				2017				2017			
Quarter	3	4			3	4			3	4		
COMPONENTS												
Real economy	0.02	0.02			0.57	0.54			3.6	3.7		
Excluding real economy	0.04	0.04			1.01	0.99			3.5	3.6		
Real economy & other aspects	3.55	3.69			98.42	98.47			3.6	3.7		
Fiscal	0.28	0.30			8.15	8.34			3.5	3.6		
Prices	0.57	0.54			15.94	14.69			3.6	3.7		
Exchange rates	0.13	0.11			3.59	2.96			3.5	3.6		
Interest rates, spreads	0.90	1.00			25.22	27.51			3.6	3.6		
Stock markets	0.63	0.69			17.03	18.02			3.7	3.8		
Economic sentiment	0.78	0.81			20.99	20.54			3.7	3.9		
Loans, deposits	0.27	0.24			7.51	6.40			3.6	3.8		
FORECAST												
	3.6	3.7										
CONTRIBUTION BY COMPONENT					WEIGHT				FORECAST BY COMPONENT			
Year	2018				2018				2018			
Quarter	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
Real economy	0.02	0.02	0.01	0.01	0.48	0.47	0.42	0.39	3.5	3.3	3.4	3.2
Excluding real economy	0.03	0.03	0.03	0.02	0.93	0.91	0.87	0.83	3.4	3.3	3.0	2.8
Real economy & other aspects	3.52	3.37	3.22	3.01	98.58	98.62	98.71	98.78	3.6	3.4	3.3	3.1
Fiscal	0.25	0.23	0.24	0.23	7.40	7.40	7.00	6.68	3.4	3.1	3.4	3.4
Prices	0.50	0.50	0.52	0.49	14.55	15.46	15.84	15.29	3.4	3.2	3.3	3.2
Exchange rates	0.10	0.09	0.09	0.10	2.89	2.86	2.98	3.05	3.4	3.0	3.1	3.2
Interest rates, spreads	0.99	0.90	0.89	0.92	29.14	28.90	32.96	38.09	3.4	3.1	2.7	2.4
Stock markets	0.66	0.64	0.59	0.51	17.58	17.60	16.37	14.50	3.7	3.6	3.6	3.5
Economic sentiment	0.78	0.75	0.60	0.51	20.40	19.72	16.28	14.40	3.8	3.8	3.7	3.5
Loans, deposits	0.25	0.26	0.29	0.27	6.62	6.68	7.28	6.78	3.8	3.9	4.0	4.0
FORECAST												
	3.6	3.4	3.3	3.0								



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