



ECONOMIC OUTLOOK

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Summary

Real GDP growth in Cyprus is projected at -5.7% in 2020 as a result of the COVID-19 pandemic. The contraction of GDP in 2020 is estimated to be smaller than the forecast in the previous issue due to the stronger-than-anticipated rebound in economic activity in Cyprus and abroad, following the lockdowns in the spring.

In 2021, the Cypriot economy is expected to recover as real GDP growth is projected at 3.7%. The growth forecast for 2021 is revised downwards relative to the forecast in the previous issue, due to the resurgence of the pandemic in the last months of 2020 and the renewed containment measures.

The balance of risks to the outlook is tilted to the downside. Downside risks arise from the introduction of stricter measures to curb the spread of the pandemic, especially the new lockdown in January. Additional risks stem from delays in the vaccine rollout and vaccinations in Cyprus and the EU, as well as from a new wave of infections due to new variants of the virus. Slower-than-anticipated progress with vaccinations and/or a new surge in infections will cause setbacks to the reopening of economic sectors and slow down the recovery of domestic activity and external demand, particularly demand for tourist services. Other risks relate to pressures on public finances and a possible re-escalation in NPLs as the pandemic persists. Further delays in the implementation of overdue structural reforms (e.g. judicial system, public administration, local authorities) may undermine the country's credibility, limit access to EU funds and weigh on the growth prospects.

In 2021, CPI inflation is projected to rise to 0.8% from -0,6% in 2020 as the economy is expected to recover.

Φεβρουάριος 2021

Περίληψη

Ο ρυθμός μεταβολής του πραγματικού ΑΕΠ στην Κύπρο το 2020 εκτιμάται σε -5,7%, ως αποτέλεσμα της πανδημίας COVID-19. Η συρρίκνωση του ΑΕΠ κατά το 2020 εκτιμάται ότι ήταν μικρότερη από την προβλεπόμενη, αφού η βελτίωση της οικονομικής δραστηριότητας που ακολούθησε την άρση των περιοριστικών μέτρων, τα οποία εφαρμόστηκαν την άνοιξη, ήταν ισχυρότερη από την αναμενόμενη.

Το 2021, η κυπριακή οικονομία προβλέπεται να ανακάμψει, με τον ρυθμό μεγέθυνσης του πραγματικού ΑΕΠ να εκτιμάται σε 3.7%. Η πρόβλεψη για το 2021 έχει αναθεωρηθεί προς τα κάτω λόγω της έξαρσης της πανδημίας κατά τους τελευταίους μήνες του 2020 και της αυστηροποίησης των περιοριστικών μέτρων.

Οι κίνδυνοι για δυσμενέστερες από τις προβλεπόμενες προοπτικές κυριαρχούν. Πιθανοί κίνδυνοι απορρέουν από την επιβολή αυστηρότερων περιοριστικών μέτρων για αναχαίτηση της πανδημίας και ειδικότερα του νέου απαγορευτικού τον Ιανουάριο. Επιπλέον κίνδυνοι πηγάζουν από τυχόν καθυστερήσεις στη διαθεσιμότητα εμβολίων και στα προγράμματα εμβολιασμού στην Κύπρο και στην ΕΕ, καθώς και από ένα νέο κύμα λοιμώξεων λόγω μεταλλάξεων του ιού. Βραδύτεροι ρυθμοί στους εμβολιασμούς ή/και μια νέα έξαρση των κρουσμάτων ενδέχεται να προκαλέσουν καθυστερήσεις στην επαναδραστηριοποίηση κλάδων της οικονομίας και να επιβραδύνουν την ανάκαμψη της εγχώριας δραστηριότητας και της εξωτερικής ζήτησης, κυρίως της ζήτησης για τουριστικές υπηρεσίες. Άλλοι κίνδυνοι για τις προοπτικές σχετίζονται με ενδεχόμενες πιέσεις στα δημόσια οικονομικά και πιθανή εκ νέου κλιμάκωση των μη εξυπηρετούμενων δανείων ενόσω η πανδημία παραμένει. Περαιτέρω καθυστερήσεις στην εφαρμογή διαρθρωτικών μεταρρυθμίσεων (π.χ. δικαστικό σύστημα, δημόσια διοίκηση, τοπικές αρχές) ενδέχεται να υπονομεύσουν την αξιοπιστία της χώρας, να περιορίσουν την πρόσβαση σε κονδύλια της ΕΕ και να επηρεάσουν τις προοπτικές ανάπτυξης.

Ο πληθωρισμός το 2021 προβλέπεται να αυξηθεί σε 0,8% από -0,6% το 2020, καθώς η οικονομική δραστηριότητα αναμένεται να ανακάμψει.

UNIVERSITY OF CYPRUS



1. Recent developments

The first half of 2020 was marked by the outbreak of the COVID-19 pandemic and the containment measures taken globally, including in Cyprus, leading to an unprecedented contraction of economic activity, particularly in the second quarter of 2020. The gradual relaxation of the containment measures in Cyprus, which started in May, led to a rebound in activity in the third quarter of 2020; nevertheless, output remained below its level in the corresponding quarter in 2019. The year-on-year (y-o-y) contraction of real GDP in Cyprus decelerated to 4.4% in the third quarter of 2020 from 12.3% in the second quarter.

The hardest hit sector, namely trade, transportation, accommodation and food service activities registered a double-digit decline (y-o-y) in its gross value added in the third quarter; however, the contraction was much less severe than the drop in the second quarter. The industrial sector, arts and entertainment, as well as financial activities continued to post output declines (y-o-y) in the third quarter, but of smaller magnitude compared to those in the second quarter. In the third quarter, construction and, to a smaller degree, professional activities almost returned to their levels recorded in the corresponding quarter in 2019. Information and communication, real estate activities, as well as public administration, health and education continued to grow (y-o-y) throughout the first three quarters of 2020. Following the sharp fall in the second quarter, private consumption recovered strongly in the third quarter, surpassing its level in the same quarter in 2019. The consumption expenditure of the general government continued to rise, albeit at a slower pace vis-à-vis the first two quarters of 2020. In the third quarter, the drop (y-o-y) in gross fixed capital formation moderated, mainly because the contraction in construction investment decelerated significantly. Net exports worsened considerably in the third quarter as the decline (y-o-y) in exports deepened further, while the decrease (y-o-y) in exports eased.

The recovery in a number of domestic activity indicators continued in the final quarter of 2020 (e.g. new company registrations, number of property sale contracts by foreigners, tourist arrivals from the UK, credit card use by foreigners). However, in many cases the recovery was driven by improvements registered in October, when the number of COVID-19 infections was relatively low. For another group of activity indicators, the progress made in the third quarter

was not sustained in the final quarter (e.g. motor vehicle registrations, total number of property sale contracts).

The Economic Sentiment Indicator (ESI) in the final quarter of 2020 did not change significantly from the level reached in the third quarter, following the reopening of the economy; the ESI stayed below both its historical average and the EU-wide ESI. In the fourth quarter, business confidence in services and retail trade remained stable, while confidence in construction and manufacturing edged down. Firms' employment expectations strengthened further in the fourth quarter, mainly driven by improvements recorded in October. Consumer confidence deteriorated in the final quarter of 2020.

Registered unemployment continued to increase in the fourth quarter of 2020, but at a slower pace compared to the second and third quarters. Registered unemployed workers in hospitality, trade and transport accounted for almost 50% of the total in December. In the final quarter of 2020, the rise in registered unemployment accelerated significantly for newcomers and the construction sector. The unemployment rate (Eurostat) declined to 7.8% in November from the year's peak (10.5%) in October.

As a result of the pandemic, the general government deficit has been widening, driven by reduced revenue and rising expenditure. Moreover, public debt peaked in November; nevertheless, long-term interest rates for Cyprus declined to an all-time low in the final quarter of 2020.

In October - November, domestic deposits continued to rise at modest rates and the annual growth rate of the domestic loan stock accelerated. New lending over the period from September to November registered strong growth (y-o-y), although new credit for the first 11 months of 2020 remained subdued compared to the same period in 2019. The very low levels of lending interest rates together with measures for counteracting 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 continue to support business liquidity and household incomes. Despite the adverse economic conditions due to the pandemic, the stock of non-performing loans (NPLs) continued its downward trend in January - September; the ratio of non-performing loans (NPLs) to total facilities stood at just above 20% in September.

Inflation (measured by the Consumer Price Index - CPI) remained negative in the final quarter of 2020, at -0.8% from -1.2% in the third quarter. Overall, inflation in 2020 declined

to -0.6% from 0.3% in 2019, mainly driven by negative inflation in the categories of transport, housing, water and energy.

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 third quarter of 2020 are employed. Monthly indicators that contain information about some or all the months in the fourth quarter of 2020 are also used. The cut-off date for the data used in the analysis is 18 January 2021. All forecasts presented in this bulletin are based solely on published data; thus, they only incorporate effects captured by the indicators used in the estimations.

Table 1 presents the forecasts for the growth rate of real GDP for 2020 and 2021. Based on the historical relationships between growth and numerous macroeconomic and financial indicators, real economic activity in Cyprus is projected to register a strong recovery in 2021, following the abrupt contraction in 2020 as a result of the COVID-19 pandemic. Real GDP is estimated to have dropped by 5.7% in 2020, a smaller-than-anticipated contraction driven by the strong rebound in activity in the third quarter of the year. In 2021, real GDP is projected to rise by 3.7%.

Table 1 also shows the contribution of different components (groups of models) towards shaping the final forecasts. 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 forecasts.¹ The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts.^{2, 3}

¹ 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.

² Monthly leads of leading indicators (e.g. interest rates, economic sentiment) and monthly leading values of series used in extracting

Table 1: GDP growth forecasts and components

Year	2020		
FORECAST	-5.7		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	-0.02	0.44	-4.8
II. Aspects other than real economy	-0.02	0.50	-4.6
III. Real economy & other aspects	-5.61	99.06	-5.7
Fiscal	-0.33	5.81	-5.6
Prices	-0.63	11.18	-5.6
Exchange rates	-0.20	3.52	-5.6
Interest rates, spreads	-1.09	19.20	-5.7
Stock markets	-0.80	14.18	-5.7
Economic sentiment, uncertainty	-2.07	36.60	-5.7
Loans, deposits	-0.49	8.58	-5.7
Year	2021		
FORECAST	3.7		
	CONTRIBUTION	WEIGHT	FORECAST BY COMPONENT
COMPONENTS			
I. Real economy	0.02	0.47	4.0
II. Aspects other than real economy	0.02	0.51	4.3
III. Real economy & other aspects	3.69	99.02	3.7
Fiscal	0.22	5.59	3.9
Prices	0.42	11.16	3.8
Exchange rates	0.12	3.29	3.7
Interest rates, spreads	0.82	22.20	3.7
Stock markets	0.52	14.30	3.7
Economic sentiment, uncertainty	1.33	36.01	3.7
Loans, deposits	0.25	6.48	3.8

the factors (e.g. unemployment rate, registered unemployed, arrivals of tourists, registrations of motor vehicles) are also included in the models.

³ Economic sentiment indicators refer to data obtained through the Joint Harmonised EU 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.

The forecasts incorporate the disruption in economic activity due to the containment measures implemented in the spring, and the resumption of economic activity that followed, captured by published data. Also, the growth forecasts reflect, through leading indicators, possible setbacks to the economic recovery due to ongoing and renewed measures and restrictions to control the new wave of COVID-19 infections in Cyprus and abroad. The drivers of the outlook, as well as challenges to the recovery are discussed below.

- *Strong rebound in activity.* Following the collapse of economic activity in the second quarter of 2020, real GDP in Cyprus and the EU registered a strong rebound in the third quarter. Moreover, the decline (y-o-y) in employment in the second and third quarters was less severe than the contraction in output, due to policy measures to safeguard jobs and support businesses. The various support measures implemented together with the stronger-than-expected rebound in activity are estimated to have limited the depth of the contraction in 2020 and to facilitate the recovery in 2021. However, fourth quarter leading indicators for Cyprus (e.g. motor vehicle registrations, property sale contracts, registered unemployed) and the EU (e.g. retail sales) point to difficulties in the recovery process, due to a new wave of infections and renewed containment measures. Thus, the resurgence of the pandemic in Cyprus and abroad will dampen the recovery momentum in 2021.
- *Strong fiscal policy response.* The prompt adoption of a sizeable fiscal package has mitigated the economic impact of the pandemic, despite increases in the deficit and public debt. Loans through EU support instruments (e.g. SURE), as well as additional policy measures to counteract the effects of the second COVID-19 wave, are expected to continue to back the real economy.
- *Low inflation.* Inflation in Cyprus remained in negative territory after the onset of the pandemic in March. International oil prices continued to recover in the final quarter of 2020, but stayed well below their pre-pandemic levels. Thus, the absence of upward price pressures continues to support real incomes and the recovery.
- *Supportive financial conditions.* Borrowing costs in the euro area (including Cyprus) have remained at very low levels, reflecting the supportive monetary policy stance. The improved conditions in the domestic banking system compared to the previous crisis, as well as the schemes to support viable borrowers and new lending are conducive to a swift recovery. Nevertheless, vulnerabilities associated with the previous crisis, such as the high indebtedness levels and the large stock of NPLs could weigh on growth, particularly in the medium term. International stock

markets signal improvements to external economic conditions as they continued to recover in the second half of 2020, despite a setback in October. However, many stock market indices remain below their pre-pandemic levels and volatility fluctuates above the 2019 levels, reflecting uncertainties about the recovery momentum in major economies.

- *Stable economic sentiment.* The pickup of economic confidence in Cyprus in the third quarter will continue to support activity, but the absence of further improvements in the final quarter of 2020 softens the growth prospects. The rise in economic sentiment at the EU-level is expected to facilitate the recovery in Cyprus in the following quarters, by creating a favourable external environment.

The resurgence of the pandemic in the last months of 2020 and the renewed containment measures have considerably increased the uncertainty surrounding the outlook. Downside risks to the outlook are dominant. Downside risks to the outlook stem from the introduction of stricter measures to curb the spread of the virus in the last months of 2020, and the new lockdown in January, to the extent that the negative impact on economic activity is not adequately reflected in published data. Moreover, significant risks that may negatively affect the outlook include delays in the vaccine availability and vaccinations in Cyprus and the EU, as well as a new wave of infections due to new variants of the virus. Slower-than-anticipated progress with vaccinations and/or a new surge in infections will cause setbacks to the reopening of economic sectors and slow down the recovery of domestic activity and external demand, particularly demand for tourist services. Additional risks relate to pressures on public finances and a possible re-escalation in NPLs as the pandemic persists. Further delays in the implementation of overdue structural reforms (e.g. judicial system, public administration, local authorities) may undermine the country's credibility, limit access to EU funds and weigh on the growth prospects.

Upside risks to the outlook through positive effects on confidence and demand include the following: a faster-than-expected vaccine rollout and vaccination process in Cyprus and the EU, the availability of effective COVID-19 therapies, and a steady improvement in the epidemiological conditions in Cyprus and abroad. Moreover, positive effects on the outlook, as well as on the medium-term prospects could arise from the successful absorption of EU funds and optimal use of the available EU instruments to mitigate the impact of the pandemic.

In 2021, CPI inflation is projected to rise to 0.8% from -0.6% in 2020 as the economy is expected to recover. The projection for muted inflation in 2021 is driven by the recent negative inflation rates in Cyprus, as well as by subdued international oil prices in 2020.⁴ Upside risks to the forecast include faster increases in international commodity prices, particularly oil prices, and stronger-than-expected growth in Cyprus and abroad. Downside risks to the inflation outlook are associated with a weaker-than-anticipated recovery in domestic and global activity, as well as downward pressures on international commodity prices.

3. Concluding remarks

Quarterly and monthly series released up until 18 January 2021, are employed in dynamic econometric models to construct forecasts for growth and inflation. The published data incorporate the disruption in economic activity due to the containment measures implemented in the spring and the resumption of economic activity that followed. Leading indicators for the final quarter of 2020 reflect possible setbacks to the economic recovery due to ongoing and renewed measures and restrictions to control the new wave of COVID-19 infections.

Real GDP growth in Cyprus is forecast at -5.7% in 2020, a less severe decline than the projection presented in the November issue (-6.5%). The upward revision is driven by the stronger-than-expected rebound in economic activity in Cyprus and abroad after the lockdowns in the spring. In 2021, real GDP growth in Cyprus is projected at 3.7%. The growth forecast for 2021 is revised downwards relative to the

forecast in the November issue (4.2%), mainly due to the resurgence of the pandemic in the last months of 2020 and the renewed containment measures.

In 2021, CPI inflation is projected at 0.8%, a downward revision by 0.2 percentage point compared to the November issue. The downward revision is largely driven by the recent negative inflation rates in Cyprus and the absence of upward pressures on international oil prices in 2020.

The growth forecast for 2020 presented in this bulletin is somewhat less pessimistic than the projections published by the Central Bank (baseline scenario) and the European Commission (-6.2%). The growth forecast for 2021 is along the same lines as the forecast by the European Commission and slightly lower than the baseline projection by the Central Bank (4.1%) [1] - [2].

The forecasts in this issue are accompanied by significant downside risks as economic outcomes largely depend on the evolution of the pandemic in combination with the availability of vaccines and the vaccination progress in Cyprus and abroad.

REFERENCES

1. Central Bank of Cyprus, "Economic Bulletin - December 2020", Nicosia - Cyprus (in Greek), December 2020.
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⁴ CPI inflation forecasts are constructed using a methodology similar to that described for GDP growth forecasts.



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