



Issue 17/3

# ECONOMIC OUTLOOK

## ECONOMICS RESEARCH CENTRE

July 2017

### SUMMARY

The expansion of real economic activity in Cyprus is expected to continue at robust rates in 2017 and 2018. In 2017, real GDP is projected to grow by 3.0%. In the second and third quarters of 2017, real GDP is projected to rise (year-on-year) by 2.9% and in the final quarter of the year GDP growth is estimated at 2.8%. In 2018, real GDP growth is forecasted to slightly decelerate to 2.7%.

The factors driving the solid growth rates forecasted for the following quarters are given below:

- Robust activity and employment growth in Cyprus in the first quarter of 2017.
- Further positive developments in domestic leading indicators in the second quarter of the year and strong domestic economic sentiment.
- Improving domestic financial conditions, marked by deposit growth and deleveraging, as well as the low levels of lending interest rates.
- Favourable external economic conditions, such as steady growth and strong economic sentiment in the EU and the euro area, the resilience of the UK economy amid uncertainty after the Brexit vote, the recovery of the Russian economy and the favourable performance of international stock markets.

Other factors, such as the strong fiscal performance and the low levels of European interest rates (reflecting the accommodative monetary policy stance) facilitated the recovery in Cyprus as discussed in previous issues. Nevertheless, as growth gains momentum, the positive effects of these factors on the outlook weaken. The absence of upward pressures to the general price level in the past few years has also backed the economic recovery through its beneficial effects on purchasing power. However, as international oil prices and demand pick up, the positive impact of lower prices on real incomes and growth wanes.

Downside risks to the growth forecasts are discussed below:

- The high ratio of public debt to GDP renders Cyprus vulnerable to negative shocks. Delaying structural reforms and relaxing fiscal discipline, especially in view of the upcoming elections, may undermine the sustainability of public finances and growth.
- 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 (through e.g. restructurings, debt-to-asset swaps, third-party loan servicers). The large volume of problematic assets on banks' balance sheets and the high indebtedness levels deprive the economy of growth-enhancing investment.
- Slower-than-expected growth in the UK and further depreciation of the pound against the euro, as a result of increased uncertainty during the Brexit negotiations, 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 reach 1.3% and in 2018, inflation is projected to pick up to 1.9%, as activity continues to expand and international oil and food prices gradually rebound.





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#### 1. Recent developments

Growth in Cyprus strengthened in the first quarter of 2017 as real GDP increased by 3.3%, year-on-year (y-o-y), compared with 2.9% in the final quarter of 2016. In the first quarter of 2017, all sectors expanded (y-o-y) in terms of their real gross value added, except for agriculture, and financial and insurance services. The latter has been the worst-performing sector in terms of real activity growth for five consecutive quarters. Private consumption picked up further in the first quarter but at a somewhat slower pace compared with the previous three quarters; government consumption expenditure rose only marginally. The expansion of gross capital formation, driven by the increase in transport equipment and the recovery of construction investment, was the largest contributor to GDP growth in the first quarter. At the same time, the contribution of net exports to growth was quite negative, as imports increased while exports shrank (y-o-y).

Many domestic leading indicators (e.g. credit card use by locals and tourists, tourist arrivals, registrations of motor vehicles, number of property sale contracts, the Cyprus stock exchange index) continued to pick up during the second quarter of 2017. The Economic Sentiment Indicator (ESI) rose further in the second quarter, reaching historically high levels; the increase in economic sentiment was driven by a confidence boost in services and small increases in retail trade and consumer confidence.

The decline in the number of registered unemployed accelerated in the second quarter of 2017. In the first quarter of the year, the unemployment rate (Eurostat) fell below 13%; in April and May 2017 unemployment dropped to about 11%.

Over the period January – May 2017, government revenue increased faster than expenditure and budget surplus more than quadrupled compared with the same period in 2016. Public debt has been slowly declining since February 2017.

Deposits held in Cyprus by domestic and other euro area residents continued to rise during the first five months of 2017. The contraction of the stock of total loans as a result of deleveraging and subdued new credit continued over January – May 2017 but at slower rates than those registered in 2016. Interest rates remain low by historical standards. In spite of the recent progress, the high level of non-performing exposures relative to the size of the

economy, continues to pose a challenge to financial and macroeconomic soundness.

Inflation (measured by the Consumer Price Index – CPI) declined to 1.2% in the second quarter of 2017 from 1.4% in the first quarter; inflation in the second quarter was mainly driven by price increases in the categories of housing–water–energy, transport and food.

#### 2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the first quarter of 2017. Monthly indicators released by 17 July 2017 that contain information covering all the months in the second 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 second, 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.<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 at robust rates in 2017 and 2018. Real GDP growth is estimated at 3.0% in 2017. In 2018, growth is forecasted to edge down to 2.7%.
- In both the second and third quarters of 2017, real activity growth is projected at 2.9%; real GDP is forecasted to rise by 2.8% in the fourth quarter of the year.
- Real GDP growth is estimated to remain solid at about 2.8% in the first half of 2018 and subsequently to ease to 2.6% 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

<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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activity and labour market), and components in the group which *excludes real economy* factors, have a minor effect on the formation of the forecasts in all quarters (about 1.3%).<sup>2</sup> 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<sup>1</sup>**

YEAR	2017			
<b>FORECAST<sup>2</sup></b>	<b>3.0</b>			
<b>Quarter</b>	<b>2</b>	<b>3</b>	<b>4</b>	
<b>FORECAST (y-o-y)</b>	<b>2.9</b>	<b>2.9</b>	<b>2.8</b>	
Forecast error <sup>3</sup>	0.7	1.1	1.9	
<b>COMPONENTS<sup>4</sup></b>				
<b>Real economy</b>	<b>0.02</b>	<b>0.01</b>	<b>0.01</b>	
<b>Excluding real economy</b>	<b>0.03</b>	<b>0.02</b>	<b>0.02</b>	
<b>Real economy &amp; other aspects</b>	<b>2.84</b>	<b>2.86</b>	<b>2.74</b>	
Fiscal	0.22	0.20	0.16	
Prices	0.49	0.47	0.45	
Exchange rates	0.10	0.08	0.07	
Interest rates, spreads	0.69	0.76	0.73	
Stock markets	0.49	0.54	0.54	
Economic sentiment	0.63	0.61	0.59	
Loans, deposits	0.22	0.21	0.20	
YEAR	2018			
<b>FORECAST</b>	<b>2.7</b>			
<b>Quarter</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>FORECAST (y-o-y)</b>	<b>3.0</b>	<b>2.7</b>	<b>2.5</b>	<b>2.6</b>
Forecast error <sup>3</sup>	2.8	3.2	3.7	4.1
<b>COMPONENTS<sup>4</sup></b>				
<b>Real economy</b>	<b>0.01</b>	<b>0.01</b>	<b>0.01</b>	<b>0.01</b>
<b>Excluding real economy</b>	<b>0.02</b>	<b>0.02</b>	<b>0.02</b>	<b>0.02</b>
<b>Real economy &amp; other aspects</b>	<b>2.92</b>	<b>2.66</b>	<b>2.52</b>	<b>2.60</b>
Fiscal	0.17	0.16	0.17	0.19
Prices	0.51	0.49	0.46	0.47
Exchange rates	0.07	0.08	0.08	0.08
Interest rates, spreads	0.75	0.67	0.65	0.67
Stock markets	0.59	0.52	0.46	0.47
Economic sentiment	0.59	0.48	0.43	0.41
Loans, deposits	0.24	0.26	0.26	0.29

<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 quarter of 2017 the y-o-y growth rate of GDP obtained from published data is used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 09/06/2017).

<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.

<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).

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 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 accelerated in the first quarter of 2017. Domestic leading indicators suggest that labour market conditions were improving during the first half of 2017; economic activity expanded further in the second quarter the year.
- *Strong domestic economic sentiment.* Confidence gains registered among firms, particularly in services, and among consumers in the first half of 2017 point to firm growth in the following quarters.
- *Improving domestic financial conditions.* The ongoing recovery of the banking sector (marked by e.g. deposit growth and deleveraging) and the low levels of lending interest rates continue to support growth.
- *Favourable external economic conditions.* In the first quarter of 2017, activity in the EU and the euro area continued to expand at a steady pace, the UK economy continued to show resilience amid uncertainty after the Brexit vote, and the recovery of the Russian economy progressed. Moreover, in the first half of 2017, economic sentiment in the EU and the euro area strengthened further and the performance of international stock markets remained positive, suggesting a favourable external economic environment.

Other factors, such as the strong fiscal performance and the low levels of European interest rates (reflecting the accommodative monetary policy stance) facilitated the recovery in Cyprus as discussed in previous issues. Nevertheless, as growth gains momentum, the positive effects of these factors on the outlook weaken towards the end of the forecast horizon. The absence of upward pressures to the general price level in the past few years has also backed the economic recovery through its beneficial effects on purchasing power. However, as international oil prices and demand pick up, the positive impact of lower prices on real incomes and growth wanes.



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Developments in the exchange rates of the currencies of Cyprus's main trading partners are found to have some dampening effects on growth projections, especially towards the end of the forecast horizon. The prolonged period of weak Russian rouble and the recent depreciation of the British pound have squeezed tourists' spending in Cyprus.

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

- The high ratio of public debt to GDP renders Cyprus vulnerable to negative shocks. Delaying structural reforms and relaxing fiscal discipline, especially in view of the upcoming elections, may undermine the sustainability of public finances and growth.
- 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 (through e.g. restructurings, debt-to-asset swaps, third-party loan servicers). The large volume of problematic assets on banks' balance sheets and the high indebtedness levels deprive the economy of growth-enhancing investment.
- Slower-than-expected growth in the UK and further depreciation of the pound against the euro, as a result of increased uncertainty during the Brexit negotiations, 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 reach 1.3% and in 2018, inflation is projected to pick up to 1.9%, as activity continues to expand and international oil and food prices gradually rebound.<sup>3</sup> 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.

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

### 3. Concluding remarks

Quarterly data available up to the first quarter of 2017, and monthly indicators available up to the second quarter of the year and released until 17 July 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 3.1% in the May issue to 3.0%. The slight downward revision resulted from the lower-than-forecasted growth rate in the first quarter of 2017. Moreover, the effects of some macroeconomic developments (e.g. strong fiscal performance, low/negative past inflation, recovering deposits, declining stocks of loans) on growth projections were less pronounced compared to the previous two issues.

The CPI inflation projection for 2017 has been revised from 1.7% in the previous issue to 1.3%. The forecast has been revised downwards, as international oil and non-energy commodity (food) prices have increased at slower rates compared with the first quarter of the year, and inflation has decelerated slightly in the second quarter.

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 (2.5%), but it is similar to the projection provided by the Central Bank of Cyprus (3.1%) [1], [2]. For 2018, the growth forecast in this bulletin is higher than the growth rate forecasted by the European Commission (2.3%), but it is less optimistic than the growth projection of the Central Bank (3.2%) [1], [2].

### REFERENCES

1. Central Bank of Cyprus (2017), "Economic Bulletin - June 2017", Nicosia - Cyprus (in Greek).
2. European Commission, "European Economic Forecast: Spring 2017", European Economy Institutional Paper 053, May 2017.

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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	2	3	4	2	3	4	2	3	4			
COMPONENTS												
Real economy	0.02	0.01	0.01	0.57	0.51	0.47	2.8	2.8	2.6			
Excluding real economy	0.03	0.02	0.02	0.90	0.87	0.83	2.9	2.8	2.8			
Real economy & other aspects	2.84	2.86	2.74	98.53	98.62	98.70	2.9	2.9	2.8			
Fiscal	0.22	0.20	0.16	7.82	8.03	6.90	2.8	2.5	2.3			
Prices	0.49	0.47	0.45	17.30	16.24	16.21	2.9	2.9	2.8			
Exchange rates	0.10	0.08	0.07	3.39	2.80	2.73	2.8	2.7	2.7			
Interest rates, spreads	0.69	0.76	0.73	24.67	27.38	28.79	2.8	2.8	2.5			
Stock markets	0.49	0.54	0.54	16.24	17.10	17.18	3.0	3.2	3.2			
Economic sentiment	0.63	0.61	0.59	21.43	20.12	20.00	2.9	3.0	2.9			
Loans, deposits	0.22	0.21	0.20	7.67	6.97	6.88	2.9	2.9	2.9			
<b>FORECAST</b>												
	<b>2.9</b>	<b>2.9</b>	<b>2.8</b>									
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	0.01	0.01	0.01	0.01	0.46	0.43	0.39	0.44	2.8	2.8	2.8	2.7
Excluding real economy	0.02	0.02	0.02	0.02	0.83	0.84	0.85	0.88	2.9	2.6	2.4	2.6
Real economy & other aspects	2.92	2.66	2.52	2.60	98.71	98.73	98.76	98.68	3.0	2.7	2.5	2.6
Fiscal	0.17	0.16	0.17	0.19	7.02	6.74	6.37	6.95	2.4	2.4	2.6	2.7
Prices	0.51	0.49	0.46	0.47	17.59	17.58	16.97	17.82	2.9	2.8	2.7	2.7
Exchange rates	0.07	0.08	0.08	0.08	2.69	2.97	2.97	3.19	2.8	2.6	2.6	2.6
Interest rates, spreads	0.75	0.67	0.65	0.67	28.97	32.35	35.73	33.26	2.6	2.1	1.8	2.0
Stock markets	0.59	0.52	0.46	0.47	16.64	15.61	14.55	14.93	3.5	3.3	3.2	3.1
Economic sentiment	0.59	0.48	0.43	0.41	18.89	16.27	15.26	14.82	3.1	3.0	2.8	2.8
Loans, deposits	0.24	0.26	0.26	0.29	6.91	7.22	6.90	7.71	3.4	3.5	3.7	3.8
<b>FORECAST</b>												
	<b>3.0</b>	<b>2.7</b>	<b>2.5</b>	<b>2.6</b>								



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# **ECONOMIC OUTLOOK**

## **ECONOMICS RESEARCH CENTRE**

**July 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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