



Issue 19/2

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

May 2019

Summary

The Cypriot economy is projected to grow at robust rates in 2019 and 2020, albeit at a somewhat slower pace vis-à-vis the growth rate of 3.9% registered in 2018. In 2019, real GDP growth is projected to decelerate to 3.5%. Real GDP growth for 2020 is projected at 3.4%. The main drivers of the outlook include the strong economic performance in Cyprus in the previous quarters, muted inflation, improving conditions in the domestic banking sector, the strong fiscal performance in Cyprus, supportive financial conditions, and high levels of economic confidence. The moderation in the growth momentum projected for 2019 and 2020 is mainly driven by a weaker performance of some domestic economic indicators, and slower growth in the EU and the euro area reflected in hard and soft data.

The forecast for 2019 has been revised up by 0.4 percentage points relative to the January issue. The upward revision is mainly driven by the better-than-predicted outcome for the final quarter of 2018. The upward revision also reflects favourable developments after the third quarter of 2018, such as low inflation, strong fiscal performance and less adverse financial conditions (e.g. improved performance of international stock markets and declining spreads in the euro area).

Downside risks to the projections may stem from slower progress with private sector deleveraging and with the reduction of NPLs, the high level of public debt together with the strong link between bank and sovereign risk, as well as from fiscal risks (e.g. court rulings on public sector pay cuts undertaken in the context of past fiscal consolidation, the newly introduced General Health System). Also, downside risks could arise from higher uncertainty surrounding the UK's exit from the EU, weaker-than-expected growth in the UK and the euro area, and geopolitical tensions in the Eastern Mediterranean.

Upside risks to the outlook are associated with a faster reduction in the stock of NPLs, and a higher degree of materialisation of investment plans (e.g. investments relating to tourism, property developments, energy) than that reflected in the predictors.

Μάιος 2019

Περίληψη

Η Κυπριακή οικονομία εκτιμάται ότι θα συνεχίσει να αναπτύσσεται με αρκετά θετικούς ρυθμούς κατά το 2019 και το 2020, αν και κάπως χαμηλότερους συγκριτικά με τον ρυθμό του 3,9% που καταγράφηκε το 2018. Το 2019, ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ προβλέπεται να μετριαστεί στο 3,5%. Ο ρυθμός μεγέθυνσης του πραγματικού ΑΕΠ για το 2020 προβλέπεται στο 3,4%. Ανάμεσα στους κυριότερους παράγοντες που συμβάλλουν στη διαμόρφωση των προοπτικών περιλαμβάνονται: οι θετικές επιδόσεις της κυπριακής οικονομίας τα προηγούμενα τρίμηνα, ο χαμηλός πληθωρισμός, η βελτίωση των συνθηκών στον εγχώριο τραπεζικό τομέα, η ισχυρή δημοσιονομική επίδοση στην Κύπρο, οι υποβοηθητικές χρηματοπιστωτικές συνθήκες και τα ψηλά επίπεδα οικονομικής εμπιστοσύνης. Η επιβράδυνση στη δυναμική της μεγέθυνσης που προβλέπεται για το 2019 και το 2020 οφείλεται κυρίως σε μετρίότερες επιδόσεις εγχώριων οικονομικών δεικτών, καθώς και στην επιβράδυνση του ρυθμού μεγέθυνσης στην ΕΕ και στην ευρωζώνη που αποτυπώνεται σε επίσημα στοιχεία και προπορευόμενους δείκτες.

Η πρόβλεψη του ρυθμού μεγέθυνσης του ΑΕΠ για το 2019 αναθεωρήθηκε προς τα πάνω κατά 0,4 ποσοστιαίες μονάδες σε σχέση με το τεύχος Ιανουαρίου. Η προς τα πάνω αναθεώρηση οφείλεται κυρίως στον ψηλότερο από τον προβλεπόμενο ρυθμό μεγέθυνσης του ΑΕΠ το τελευταίο τρίμηνο του 2018 καθώς, επίσης, και σε ευνοϊκές εξελίξεις μετά το τρίτο τρίμηνο του 2018, όπως ο χαμηλός πληθωρισμός, οι ισχυρές δημοσιονομικές επιδόσεις και οι λιγότερο δυσμενείς χρηματοπιστωτικές συνθήκες (π.χ. βελτίωση των επιδόσεων των διεθνών χρηματιστηρίων και υποχώρηση των αποδόσεων κρατικών ομολόγων στην ευρωζώνη).

Κίνδυνοι για χαμηλότερους από τους προβλεπόμενους ρυθμούς μεγέθυνσης θα μπορούσαν να προκύψουν από βραδύτερη πρόοδο στην απομόχλευση του ιδιωτικού τομέα και στη μείωση των μη εξυπηρετούμενων δανείων, το ψηλό δημόσιο χρέος σε συνάρτηση με την ισχυρότερη διασύνδεση μεταξύ τραπεζικού τομέα και κράτους και από πιθανό επιπρόσθετο δημοσιονομικό κόστος (π.χ. από δικαστικές αποφάσεις σχετικά με παλαιότερες αποκοπές μισθών στον δημόσιο τομέα, από την εφαρμογή του ΓΕΣΥ). Επιπρόσθετα, κίνδυνοι για τις προοπτικές ανάπτυξης ενδέχεται να προκύψουν από μεγαλύτερη αβεβαιότητα σχετικά με την έξοδο του Ηνωμένου Βασιλείου από την ΕΕ, χαμηλότερους από τους αναμενόμενους ρυθμούς μεγέθυνσης στην ευρωζώνη και στο Ηνωμένο Βασίλειο, καθώς και από γεωπολιτικές εντάσεις στην περιοχή της ανατολικής Μεσογείου.

Θετικότερες από τις προβλεπόμενες προοπτικές μπορούν να διαμορφωθούν λόγω ταχύτερης μείωσης των μη εξυπηρετούμενων δανείων και από μεγαλύτερο βαθμό υλοποίησης επενδύσεων από ό,τι ανατακλάται στους οικονομικούς δείκτες.

UNIVERSITY OF CYPRUS



1. Recent developments

The Cypriot economy continued to grow robustly as real GDP increased by 3.8% year-on-year (y-o-y) in the final quarter of 2018. According to revised National Accounts data, growth in Cyprus edged down in 2018, as real GDP increased by 3.9% compared with 4.5% in 2017.

In the fourth quarter of 2018, all sectors of economic activity, except financial and insurance services, continued to grow in terms of their real gross value added (y-o-y). The biggest growth contributors in the final quarter of 2018 were the sectors of construction, trade, transportation, accommodation and food services, and professional services. Consumption growth accelerated in the final quarter of 2018 driven by faster growth in the consumption expenditure of the general government, while private consumption continued to increase steadily. Despite strong growth in construction investment, gross fixed capital formation contracted (y-o-y) in the fourth quarter of 2018 as a result of lower investment in transport equipment compared with the same period in 2017. Although imports decreased faster than exports (y-o-y), net exports remained negative in the final quarter of 2018, weighing on growth.

In the first quarter of 2019, many leading indicators of domestic activity continued to register robust growth rates vis-à-vis the same period in 2018 (e.g. overall credit card use, credit card use by tourists, volume index of retail trade, index of industrial production, number of property sale contracts), while others showed signs of deterioration (e.g. tourist arrivals, registrations of motor vehicles, registrations of new companies). The Economic Sentiment Indicator (ESI) declined in the first quarter of the year as a result of lower business confidence in services, retail trade and industry as well as weaker consumer confidence. Nevertheless, the ESI for Cyprus is currently standing above its long-run average and above the euro area ESI. Firms' employment expectations were revised downwards in the first quarter but remained positive.

In the first quarter of the year, the number of registered unemployed decreased further, but at slower rates vis-à-vis those reported in 2018. Over the same period, the unemployment rate (Eurostat) declined to about 7% and below the euro area average.

In January – February 2019, government revenue increased (y-o-y) much faster than government expenditure, resulting in higher surplus compared with the same period in 2018.

Although public debt remains elevated, long-term interest rates for Cyprus declined in the first quarter of 2019.

In January – February 2019, the stock of loans declined further, but new loans to business exceeded the amounts granted over the same period in 2018. Domestic lending interest rates remain at historically low levels. The most recent data show that the stock of non-performing loans (NPLs) decreased further in December 2018, to about 30% of total facilities. However, the NPLs of households and SMEs, which account for about 90% of the NPL stock, are just below 40% of total facilities.

Inflation (measured by the Consumer Price Index – CPI) decelerated further, decreasing from 2.4% in the final quarter of 2018 to 1.5% in the first quarter of 2019. The decline in inflation was largely driven by negative inflation in the category of transport, and slower inflation in the categories of housing–water–electricity–gas, recreation and education.

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 final quarter of 2018 are employed. Monthly indicators released by 17 April 2019 that contain information about some or all the months in the first quarter of 2019 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 2019 and 2020 are shown in Table 1; the projections for the whole of 2019 and 2020 are also shown. Based on the historical relationships between growth and numerous macroeconomic and financial indicators, real economic activity in Cyprus is expected to continue to increase at robust rates in both 2019 and 2020. Nevertheless, growth is forecast to slow vis-à-vis the rates achieved in 2018.

- In 2019, real GDP is projected to increase by 3.5%. The y-o-y growth rates of GDP in 2019 are projected to lie between 3.4% and 3.6%, and the quarter-on-quarter (q-o-q) rates are estimated between 0.7% and 1.0%.
- In 2020, real GDP growth is projected at 3.4%. Growth is expected to soften in 2020, as the y-o-y and q-o-q

growth rates are estimated in the range of 3.3% to 3.4%, and 0.7% to 0.9%, respectively.

Table 1: GDP growth forecasts, forecast errors and contribution of components to forecasts¹

YEAR	2019			
FORECAST	3.5			
Quarter	1	2	3	4
FORECAST (y-o-y)	3.4	3.6	3.5	3.4
Forecast error ²	0.8	1.4	2.2	3.1
COMPONENTS³				
I. Real economy	0.02	0.03	0.02	0.02
II. Aspects other than real economy	0.04	0.04	0.03	0.03
III. Real economy & other aspects	3.39	3.57	3.48	3.32
Fiscal	0.19	0.23	0.21	0.19
Prices	0.49	0.56	0.53	0.52
Exchange rates	0.11	0.12	0.11	0.11
Interest rates, spreads	0.85	0.97	0.95	0.88
Stock markets	0.54	0.52	0.53	0.52
Economic sentiment	0.96	0.91	0.92	0.89
Loans, deposits	0.24	0.26	0.23	0.22
YEAR	2020			
FORECAST	3.4			
Quarter	1	2	3	4
FORECAST (y-o-y)	3.4	3.3	3.4	3.4
Forecast error ²	3.4	3.7	4.1	4.5
COMPONENTS³				
I. Real economy	0.02	0.02	0.02	0.02
II. Aspects other than real economy	0.03	0.03	0.03	0.03
III. Real economy & other aspects	3.35	3.28	3.32	3.33
Fiscal	0.18	0.20	0.20	0.19
Prices	0.54	0.51	0.53	0.48
Exchange rates	0.11	0.11	0.12	0.11
Interest rates, spreads	0.81	0.82	0.81	0.85
Stock markets	0.55	0.50	0.52	0.52
Economic sentiment	0.86	0.81	0.81	0.82
Loans, deposits	0.30	0.34	0.33	0.36

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.

Table 1 also presents the forecast errors associated with the estimated y-o-y growth rates in each quarter. As expected, the 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. 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 (of about 1.5%) to the overall forecasts in all quarters.¹ The component that combines information on both the real economy and other economic aspects plays a key role in forming the final forecasts. More specifically, the forecasts are mainly formed by dynamic models that include real economy factors (one at a time) together with leading indicators (one at a time), such as interest rates, spreads, economic sentiment indicators, domestic or foreign/international price indices and stock market returns.^{2, 3}

The main drivers of the outlook are discussed below.

- *Robust economic performance in Cyprus.* Throughout 2018, real GDP and employment were rising strongly, but at somewhat lower rates compared to those achieved in 2017. Developments in leading indicators during the first quarter of 2019 show that economic conditions in Cyprus have remained favourable, but activity growth has begun to slowly moderate. Slower growth in the EU and the euro area, particularly in the second half of 2018, also contributed to the projected moderation of the growth momentum.
- *Muted inflation.* Low inflation and particularly the absence of upward pressures in international commodity prices (e.g. oil prices) reinforce activity, leading to robust rates throughout the forecast horizon.
- *Improving conditions in the domestic banking sector.* The ongoing deleveraging, the declining stock of NPLs and the improving loan-to-deposit ratio are expected to continue facilitating growth.

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 (loans, deposits).

² Monthly leads of leading indicators (e.g. interest rates, economic sentiment) and monthly leading values of series used in extracting 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 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, the Ministry of Finance and the University of Cyprus for conducting the project on Business and Consumer Surveys in Cyprus.

- *Strong fiscal performance.* Following the sharp increase in government expenditure and deficit in the third quarter of 2018 (due to the sale of the Cyprus Cooperative Bank), fiscal performance has rebounded driven by strong revenue growth, contributing to a more optimistic outlook compared to the previous issue.
- *Supportive financial conditions.* The historically low levels of domestic lending interest rates, the low levels of European interest rates, and the declining spreads in the euro area are found to back activity growth in Cyprus in the following quarters; nevertheless their positive effects on the outlook wane as the forecast horizon increases. The deterioration in the performance of international stock markets eased in the first quarter of 2019, rendering external financial conditions less adverse.
- *Economic confidence still above its long-run average.* In the first quarter of the year economic sentiment indicators for Cyprus, the euro area and the EU (particularly for the UK) declined, but their current levels are still above their long-run averages, supporting economic activity in the next quarters.

Short-term indicators such as domestic and European confidence indicators and European interest rates, which reflect uncertainties about, inter alia, domestic, European and global growth, Brexit, and international trade policies, project a more conservative outlook for the Cypriot economy than other indicators.

There are downside and upside risks to the outlook that are not fully reflected in the published predictors employed in the computation of the forecasts. Risks to the outlook have remained broadly unchanged compared to the previous issue.

Downside risks to the projections may stem from slower progress with private sector deleveraging and with the reduction of NPLs, the high level of public debt together with the strong link between bank and sovereign risk, as well as from fiscal risks (e.g. court rulings on public sector pay cuts undertaken in the context of past fiscal consolidation, the newly introduced General Health System). Also, downside risks could arise from higher uncertainty surrounding the UK's exit from the EU, weaker-than-expected growth in the UK and the euro area, and geopolitical tensions in the Eastern Mediterranean.

Upside risks to the outlook are associated with a faster reduction in the stock of NPLs, and a higher degree of materialisation of investment plans (e.g. investments relating to tourism, property developments, energy) than that reflected in the predictors.

In 2019, CPI inflation is projected at 0.8%, as international oil prices remained subdued and inflation decelerated further in the first quarter of 2019.⁴ Inflation for 2020 is projected to rise to 2.4% driven by robust activity growth and rising incomes. Upside risks to the forecasts relate to stronger demand and faster wage growth, faster increases in international commodity prices, and a further weakening of the euro vis-à-vis the US dollar. Downside risks to the forecast are associated with weaker demand and downward pressures in international commodity prices.

3. Concluding remarks

Quarterly and monthly series released until 17 April 2019, are employed in dynamic econometric models to construct forecasts for growth and inflation.

The forecast for real GDP growth for 2019 has been revised from 3.1% in the January issue to 3.5%. The upward revision is mainly driven by the better-than-predicted outcome for the final quarter of 2018 together with a slight upward revision in the q-o-q GDP growth rate for the third quarter of 2018, resulting in a more optimistic growth profile. The upward revision also reflects favourable developments after the third quarter of 2018, such as low inflation, strong fiscal performance and less adverse financial conditions (e.g. improved performance of international stock markets and declining spreads in the euro area).

The CPI inflation forecast for 2019 has been revised from 1.8% to 0.8%. The downward revision is mainly the result of further deceleration in inflation in the first quarter of 2019, and subdued international oil prices.

The forecasts presented in this issue suggest that real activity in Cyprus will continue to increase at robust rates in 2019 and 2020, albeit at a slower pace vis-à-vis 2018. The GDP growth forecast for 2019 presented here is in line with the forecasts published by the IMF (3.5%) and the Ministry of Finance (3.6%), but slightly higher than the projection given by the European Commission (3.1%), [1] – [3]. The growth forecast for 2020 is more optimistic than the projections released by the Ministry of Finance (3.2%) and the European Commission (2.7%); however, it is closer to the IMF forecast (3.3%), [1] – [3].

⁴ CPI inflation forecasts are constructed using a methodology similar to that for GDP growth forecasts.

REFERENCES

1. European Commission, "European Economic Forecast, Spring 2019", European Economy, Institutional Paper 102, May 2019.
2. International Monetary Fund (IMF), "World Economic Outlook: Growth Slowdown, Precarious Recovery Washington, DC, April 2019.
3. Ministry of Finance, "Stability Programme 2019–2022", April 2019.

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	2019				2019				2019			
QUARTER	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
I. Real economy	0.02	0.03	0.02	0.02	0.66	0.70	0.59	0.62	3.5	3.6	3.6	3.4
II. Aspects other than real economy	0.04	0.04	0.03	0.03	1.09	1.01	0.85	0.87	3.5	3.7	3.5	3.3
III. Real economy & other aspects	3.39	3.57	3.48	3.32	98.26	98.28	98.56	98.51	3.4	3.6	3.5	3.4
Fiscal	0.19	0.23	0.21	0.19	5.48	6.01	5.78	5.30	3.5	3.8	3.7	3.5
Prices	0.49	0.56	0.53	0.52	14.27	15.19	14.62	14.91	3.5	3.7	3.6	3.5
Exchange rates	0.11	0.12	0.11	0.11	3.13	3.14	3.00	3.12	3.5	3.7	3.6	3.5
Interest rates, spreads	0.85	0.97	0.95	0.88	24.28	26.71	27.02	26.58	3.5	3.6	3.5	3.3
Stock markets	0.54	0.52	0.53	0.52	16.11	14.49	14.56	15.11	3.4	3.6	3.6	3.4
Economic sentiment	0.96	0.91	0.92	0.89	28.37	25.94	27.72	28.26	3.4	3.5	3.3	3.2
Loans, deposits	0.24	0.26	0.23	0.22	6.62	6.81	5.86	5.23	3.6	3.8	4.0	4.1
FORECAST	3.4	3.6	3.5	3.4								
CONTRIBUTION BY COMPONENT					WEIGHT				FORECAST BY COMPONENT			
YEAR	2020				2020				2020			
QUARTER	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
I. Real economy	0.02	0.02	0.02	0.02	0.59	0.57	0.61	0.60	3.4	3.3	3.3	3.3
II. Aspects other than real economy	0.03	0.03	0.03	0.03	0.89	0.84	0.85	0.84	3.4	3.4	3.4	3.5
III. Real economy & other aspects	3.35	3.28	3.32	3.33	98.52	98.60	98.54	98.55	3.4	3.3	3.4	3.4
Fiscal	0.18	0.20	0.20	0.19	5.14	5.45	5.52	5.54	3.5	3.6	3.6	3.5
Prices	0.54	0.51	0.53	0.48	14.90	14.47	14.95	13.91	3.6	3.5	3.6	3.5
Exchange rates	0.11	0.11	0.12	0.11	3.12	3.24	3.39	3.29	3.5	3.4	3.4	3.4
Interest rates, spreads	0.81	0.82	0.81	0.85	26.02	27.61	27.21	27.91	3.1	3.0	3.0	3.0
Stock markets	0.55	0.50	0.52	0.52	15.55	14.51	15.03	15.00	3.6	3.4	3.5	3.5
Economic sentiment	0.86	0.81	0.81	0.82	27.21	25.84	25.30	25.27	3.2	3.1	3.2	3.2
Loans, deposits	0.30	0.34	0.33	0.36	6.58	7.47	7.13	7.64	4.5	4.6	4.7	4.8
FORECAST	3.4	3.3	3.4	3.4								



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

Economics Research Centre

University of Cyprus

P.O. Box 20537, 1678 Nicosia, CYPRUS

Telephone: 22893660, Fax: 22895027

Email: erc@ucy.ac.cy

Website: www.erc.ucy.ac.cy

The bulletin "Economic Outlook" publishes results of research in the Sector of Macroeconomic Forecasts and Analysis of the CypERC. The bulletin reflects only the authors' views.* The views expressed in this bulletin do not necessarily reflect those of the CypERC Academic Advisors, the CypERC Council or the CypERC Sponsors.

* Christos Papamichael (email: papamichael.christos@ucy.ac.cy)

* Nicoletta Pashourtidou (email: n.pashourtidou@ucy.ac.cy)

The material in this document can be copied, distributed, transmitted and otherwise disseminated, but the source must be acknowledged.