



Issue 14/1

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

January 2014

SUMMARY

The contraction in economic activity is forecasted to persist during the final quarter of 2013 and throughout 2014 at rates similar to those recorded in 2013. In particular, real GDP growth for the fourth quarter of 2013 is forecasted at -5.4%. The forecast for growth in 2013 is -5.5%.

Real GDP growth for 2014 is projected at -5.4%. During the first and second quarter of 2014 real GDP is estimated to contract by 4.9%. Recession is forecasted to deepen during the second half of 2014, as the stabilisation trends which have been recorded during the last months of 2013 are not strong enough and uniform across all aspects of the economy. GDP growth for the third and fourth quarter of 2014 is projected at -6.1% and -5.5%, respectively.

Downside risks prevail at present, as the restructuring of systemic financial institutions is underway and the confidence in the banking sector is still fragile. Furthermore, downside risks are reinforced by the high levels of private sector indebtedness amidst unfavourable labour market conditions and declining incomes. In particular, downside risks that could lead to a worse outcome than that forecasted relate to the following:

- The prolonged tight financial conditions marked by limited liquidity and credit, and relatively high interest rates could have long-lasting effects on investment, employment and growth; and could result in higher than anticipated rates of non-performing loans.
- Failure to handle effectively the relaxation of transaction restrictions and large problematic loans could undermine the fragile confidence in the banking sector.
- Additional fiscal consolidation measures (e.g. reduction in social transfers, allowances, public sector payroll and/or increase in taxes) required for the achievement of fiscal targets in subsequent quarters, will impact negatively on disposable income and demand.
- Deterioration in external environment (e.g. in Russia or Europe) could negatively affect activity in Cyprus through weakening foreign demand.

Nevertheless, if the current patterns of stabilisation/improvement in various macroeconomic indicators continue, the downturn (especially in the second half of 2014) could be milder than that projected here. Upside risks for the outlook relate to the following:

- Investment decisions directly or indirectly linked to the hydrocarbon exploitation process (and to the energy sector, in general) and the tourism industry will strengthen economic confidence; and, thereby, improve growth prospects.
- The effective absorption of European funds could alleviate to some extent the contractionary effects through increased employment and economic activity.
- The agreement on the liberalisation of flights between Russia and Cyprus is expected to boost tourist arrivals further and ease the seasonality of the Cypriot tourist product, with beneficial effects on activity and employment.
- Stronger growth in the United Kingdom is conducive to an improved export performance in Cyprus.

CPI inflation is expected to remain subdued because of the recessionary conditions and the absence of significant upward pressures on oil prices. CPI inflation in 2014 is projected at 0.7%.

Overall the projections here indicate a contraction in real GDP of about 11% for the period 2013–2014 compared to 12.5% forecasted in the economic adjustment programme for Cyprus. However, the econometric models used and the available data currently do not exclude the possibility of continuation of the recession in 2015. The forecasts in this bulletin remain consistent with evidence, provided in the July and October issues, of a milder recession in 2013 than that projected in the Cyprus's programme. Nevertheless, the forecast for 2014 appears less pessimistic than previously. This strengthens the argument for a prolonged recession, as a considerable part of the adjustment costs may incur not only in 2014 but, possibly, continue in subsequent years.



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1. Recent developments

The deterioration of the Cypriot economy persisted in the third quarter of 2013, as real GDP contracted by 5.6% relative to the same quarter of 2012. The decrease in activity during the third quarter was slightly less severe than in the second quarter; however, output contraction accelerated in the third quarter in construction, financial and insurance activities, professional and administrative services, as well as in recreation and other service activities. The year-on-year (y-o-y) decline in private consumption in the third quarter was less severe than in the second quarter; while government consumption expenditure during the same period registered weak growth. Although gross capital formation continues to shrink at fast rates, its drop in the third quarter was contained by growth in fixed investment mainly associated with the natural gas exploration process, as well as by the slowdown in inventory deaccumulation. The positive contribution of net exports to growth continued during the third quarter, driven by the disproportionate reduction in imports compared to the decline in exports.

Economic confidence has steadily recovered from the historical lows reached during the second quarter as indicated by the Economic Sentiment Indicator, which has been increasing since May 2013. The improvement in firms' activity and employment perceptions/expectations registered in the third quarter of 2013 continued during the final quarter (Figure 1). At the same time consumer confidence has been rising since the third quarter, albeit at slower rates than business confidence. The Consumer Confidence Indicator remains at extraordinary low levels, signifying that consumer confidence is still very vulnerable (Figure 2).

The unemployment rate (Eurostat) rose to 17.3% in October, but remained unchanged in November as the number of registered unemployed in the last quarter grew at a slower rate than in the second and third quarter. Nevertheless, recent data indicate that the number of vacancies declined faster in September – October than in June – August.

Overall, the signals from various leading indicators of the economy are rather mixed. Provisional data for October point to a smaller (y-o-y) decrease in the volume and value of retail trade compared to previous months; the decline in the number of vehicle registrations also slowed down in November. The contraction of credit card usage (excluding the government sector) decelerated noticeably in the final quarter of 2013. Moreover, tourist arrivals increased in the

fourth quarter compared to the corresponding quarter in 2012; arrivals from Russia associated with relatively high per capita spending in Cyprus grew at a double-digit but slower rate during the final quarter than in the previous two.

Available monthly data for industrial production and cement sales (and the number of building permits) for the last quarter of 2013 indicate that the situation in the manufacturing and construction sectors has not improved relative to the third quarter. The contraction of loans to domestic corporations and households accelerated further in November manifesting the shortage of liquidity in the domestic banking system; and, to some extent, the ongoing deleveraging. Despite the slight moderation relative to previous months deposits in November continued to fall reaching mid-2007 levels.

Figure 1: Business Confidence Indicator (CypERC), Employment Expectations Indicator (CypERC) and gross value added growth (services, retail trade, construction, manufacturing)

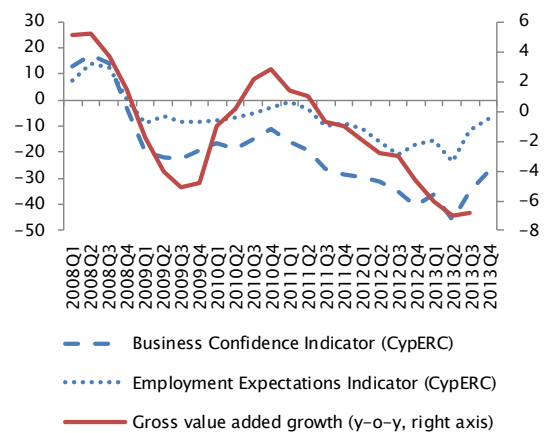
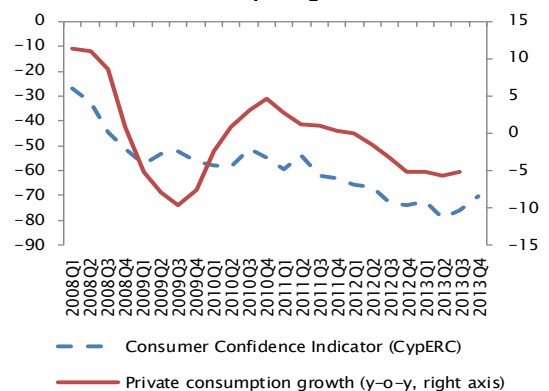


Figure 2: Consumer Confidence Indicator (CypERC) and private consumption growth



The recessionary conditions led to a decrease in the central government revenue over January – November 2013, but the

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larger decline in expenditure limited the deficit to lower levels than those recorded over the same period in 2012.

Inflation as measured by the Consumer Price Index (CPI) remained in negative territory during the final quarter of 2013, at -2.0% (y-o-y). As a result of weak domestic activity and subdued energy price inflation, CPI inflation decreased substantially, from 2.4% in 2012 to -0.4% in 2013. The negative inflation in 2013 was mainly driven by lower prices in the categories of housing, water and energy, clothing and footwear, and health.

2. Forecasts

Projections for GDP growth and CPI inflation for the fourth quarter of 2013 and all the quarters of 2014 are constructed using quarterly data available up to the third quarter of 2013. Monthly indicators released by 13 January 2014, which contain information referring to December 2013, at best, are also used.

All forecasts presented in this bulletin are based solely on published data; thus, they only incorporate effects already captured by quarterly series and monthly leading indicators used in the estimation of the forecasts.

The forecasts for the year-on-year (y-o-y) growth rate of real GDP for the fourth quarter of 2013 and all the quarters of 2014 are shown in Table 1.¹

- The contraction in economic activity is forecasted to persist during the final quarter of 2013 and throughout 2014 at rates similar to those recorded in 2013. In particular, real GDP growth for the fourth quarter of 2013 is forecasted at -5.4%. Growth for the whole of 2013 is projected at -5.5%.
- Based solely on the historical relationships between growth and numerous macroeconomic indicators recession is forecasted to deepen during the second half of 2014. Real GDP growth for 2014 is projected at -5.4%. During the first and second quarter of 2014 real GDP is estimated to contract by 4.9%. The third quarter of 2014 is the most negative of the forecasting horizon, with GDP

growth estimated at -6.1%. GDP growth for the fourth quarter of 2014 is forecasted at -5.5%.

Table 1 also shows the contribution of different components (groups of models) in shaping the final forecast. *Real economy* factors (domestic and international activity and labour market) and components in the group *other than real economy* have a minor effect on the formation of the forecast in all quarters (less than 3%).² However, *real economy jointly with other* components plays a key role in determining the forecasts.

Table 1: Contribution of components to y-o-y GDP growth forecast¹

| Year | 2013 | | 2014 | | |
|---|------|------|------|------|------|
| Quarter | 4 | 1 | 2 | 3 | 4 |
| FORECAST | -5.4 | -4.9 | -4.9 | -6.1 | -5.5 |
| COMPONENTS | | | | | |
| <i>Real economy</i> | -0.1 | -0.0 | -0.0 | -0.0 | -0.0 |
| <i>Excluding real economy</i> | -0.0 | -0.1 | -0.1 | -0.1 | -0.1 |
| <i>Real economy & other aspects</i> | -5.2 | -4.8 | -4.8 | -6.0 | -5.4 |
| Fiscal | -0.1 | -0.1 | -0.1 | -0.2 | -0.2 |
| Prices | -0.2 | -0.1 | -0.2 | -0.3 | -0.3 |
| Exchange rates | -0.1 | -0.1 | -0.1 | -0.3 | -0.2 |
| Interest rates and spreads | -1.3 | -0.9 | -1.1 | -1.3 | -1.1 |
| Stock markets | -1.1 | -1.7 | -1.4 | -1.9 | -1.5 |
| Economic sentiment | -2.1 | -1.8 | -1.5 | -1.6 | -1.5 |
| Loans and deposits | -0.4 | -0.1 | -0.3 | -0.4 | -0.4 |

Notes:

¹ Table 1 is presented in the Appendix (Table A1) in greater detail by showing the forecast resulting from each component together with the weight assigned in the computation of the final forecast. The weight of each component is determined by the number of relevant models used in the estimation and their historical forecasting performance.

² Differences between the forecasts and the sum of the components are due to rounding.

The forecasts in all quarters are mainly formed by models that include interest rates or spreads, economic sentiment or stock market indicators (and their monthly leads); as well as real economy factors and monthly values of series contained in the factors, such as the unemployment rate, registered unemployed, vacancies, arrivals of tourists, etc. Historically such models have been generating relatively more accurate forecasts; hence, they gain greater importance in the construction of the final forecast. Moreover, in recent quarters

¹ The forecasts for the year-on-year 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 forecasts presented here are computed as the average across forecasts from models that historically outperform a simple univariate model.

² The group 'other than real economy' includes: interest rates and spreads, stock market indicators, economic sentiment indicators, exchange rates, domestic and foreign price indices, international commodity prices, fiscal and banking-related series.



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the weight of forecasts from models associated with banking sector series has been increasing.

Recession in the last quarter of 2013 and in the first half of 2014 is projected less severe than in the second and third quarter of 2013. This is due to both domestic and external developments, mainly in the second half of 2013.

- Economic activity in the euro area and the United Kingdom has been weak. However, the deceleration of the GDP contraction in the euro area and Greece, the stronger growth in the UK during the second and third quarter of 2013, and the stabilisation of the unemployment rate in the euro area and Greece in the second half of 2013 create a less adverse external environment for the Cypriot economy.
- The slight moderation of the GDP contraction in Cyprus in the third quarter, recent evidence showing slowly picking up indicators related to retail trade, and a slowdown in the growth rate of registered unemployed ameliorate the depth of the recession.

In combination with the abovementioned external and domestic real economy factors, the main drivers of the less negative forecasts over the final quarter of 2013 and the first half of 2014 are the following:

- The gradual recovery of confidence in Cyprus and the improvement of sentiment in the euro area and the European Union, as indicated by the rising economic sentiment indicators during the second half of 2013.
- The improved performance of stock markets relative to 2012; although the Cyprus stock exchange continues to register negative returns (y-o-y), the outcomes after June 2013 have been less negative compared to 2012 and the first half of 2013.
- The decline in the spreads of countries in the periphery, especially those of Greece.

Recession is estimated to intensify during the third and fourth quarter of 2014 due to the lagged and persistent effects of the adverse conditions in the local real economy. Specifically, the grim state of the domestic labour market is reflected in the elevated unemployment rate and the small number of vacancies; the long-lasting contraction of investment is captured by e.g. the shrinking cement sales and motor vehicle registrations.

Other aspects of the economy which are expected to weigh on GDP growth, jointly with the aforesaid real economy factors, during the second half of 2014 are the following:

- The strengthening of the euro against the British pound and the Russian rouble appears to exert negative pressure on domestic activity through the external trade channel. These pressures become more evident in the third quarter of 2014, which is associated with the peak tourist season.
- Completed and ongoing fiscal consolidation efforts that have led to lower government deficit are found to suppress activity down the line through depressed consumption and investment.
- Persistent domestic deflation and subdued foreign inflation reflecting weak demand project acceleration of the recession in the second half of 2014; thus, contributing towards the more negative growth rates forecasted for this period. However, the ongoing easing of international oil prices, together with very low or negative inflation rates, alleviate to some extent the decline in activity up to the second quarter of 2014.
- The relatively high domestic interest rates in the presence of recessionary conditions are found to put a drag on growth, as related models give more pessimistic outcomes for the downturn in the second half of 2014 than the average forecast shown in Table 1.
- The effects of improved domestic and European sentiment indicators are estimated to contain GDP decline in the very short-run, but after the second half of 2014 are dominated by the adverse real economy conditions, whose impact is more persistent.

Forecasts are constructed using econometric techniques and, therefore, are associated with forecast errors determined by the historical performance (forecast error) of the method applied. Table 2 presents the different forecast ranges for GDP growth.

The contraction in real GDP is forecasted to accelerate in the third and last quarter of 2014, as the stabilisation trends recorded during the last months of 2013 have not been strong enough and uniform across all aspects of the economy. Nevertheless, if the current patterns in the various leading/macro-economic indicators continue (e.g. less negative retail trade/consumption indicators, stabilisation of unemployment rate and deposit outflows, growth in tourist arrivals and revenues) the downturn in the second half of 2014 could be milder than that projected here.

The quarterly profiles of the forecasts suggest that the Cyprus economy will continue incurring adjustment costs throughout 2014 at about the same rate as those registered

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in the first three quarters of 2013. Furthermore, recession in 2013 is projected less severe than in the macroeconomic scenario of the Cyprus's economic adjustment programme; slightly deeper recession than that in the programme is forecasted for 2014 ([1], [2]).

Table 2: GDP growth forecast, mean value and forecast range

| 2013 | | | | | |
|-----------------------------------|----------------|----------------|----------------|------|------|
| Quarters | 1 ¹ | 2 ¹ | 3 ¹ | 4 | 1-4 |
| Forecast | -4.9 | -5.9 | -5.6 | -5.4 | -5.5 |
| <i>Forecast range²</i> | | | | | |
| Min | -4.9 | -5.9 | -5.6 | -5.9 | -5.6 |
| Max | -4.9 | -5.9 | -5.6 | -4.8 | -5.3 |
| 2014 | | | | | |
| Quarters | 1 | 2 | 3 | 4 | 1-4 |
| Forecast | -4.9 | -4.9 | -6.1 | -5.5 | -5.4 |
| <i>Forecast range²</i> | | | | | |
| Min | -5.9 | -6.5 | -8.5 | -8.5 | -7.3 |
| Max | -3.9 | -3.2 | -3.8 | -2.5 | -3.4 |

Note: ¹ Published data (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 09/12/2013).

² The ranges are computed as \pm root mean squared forecast error around the forecasts which correspond to 68% confidence interval.

The downside risks that have been accompanying previous forecasts persist throughout the current forecast horizon. Such downside risks relate to the following:

- A prolonged period of limited credit supply and liquidity in the banking system could have long-lasting effects on investment, employment and growth.
- The current tight financial conditions (relatively high interest rates, limited liquidity/credit) together with the adverse conditions in the real economy could lead to higher than anticipated corporate and household default rates, creating further capitalisation needs for banks and accentuating recessionary conditions.
- Despite indications of stabilisation of the banking system (e.g. slight slowdown of the decline in deposits), confidence in the financial sector is still vulnerable. Thus, failure to handle effectively the relaxation of transaction restrictions and large problematic loans could undermine fragile confidence and pose risks to the outlook in the following quarters.
- To the extent that the consequences of the already legislated fiscal measures, which will take effect in 2014, are not captured by the available data (e.g. consumption indicators) their negative, albeit short-term, effect is likely to impact on activity in 2014.

- Additional fiscal consolidation measures (e.g. reduction in social transfers, allowances, public sector payroll and/or increase in taxes), required for the achievement of fiscal targets in subsequent quarters, will have negative effects on disposable income and demand.
- Deterioration of the external environment could depress activity in Cyprus further through weak external demand; IMF revised Russia's growth forecasts for 2014 downwards [3].

Upside risks for the outlook relate to the following:

- Investment decisions directly or indirectly linked to the hydrocarbon exploitation process, the energy sector in general and the tourism industry could initially strengthen economic confidence, and subsequently improve growth prospects.
- Effective absorption of European funds (e.g. structural and youth employment initiative funds) could alleviate to some degree the contractionary effects.
- The agreement on the liberalisation of flights between Russia and Cyprus is expected to boost tourist arrivals further and ease the seasonality of the Cypriot tourist product with beneficial effects on activity and employment.
- Stronger growth in the United Kingdom is conducive to an improved export performance in Cyprus, especially tourism; IMF revised United Kingdom's growth forecasts for 2014 upwards and projected stronger growth in the euro area in 2014-2015 [3].

CPI inflation in 2014 is projected at 0.7%.³ The increase of the VAT rate and the tax on motoring fuels enacted in January 2014 can be viewed as upside risks to inflation, as they are not directly incorporated in the 2014 forecast. Further rise in indirect taxes and/or in regulated prices to meet fiscal targets, increases in international commodity prices and the weakening of euro against the US dollar are also likely to put upward pressure on inflation. In contrast the contraction of real output, which is projected to continue throughout 2014 at about similar rates as those already recorded, poses considerable downside risks to inflation.

³ CPI inflation forecasts are constructed from dynamic models that include lags and monthly leads of sub-indices of CPI and domestic and foreign Harmonised Index of Consumer Prices, international commodity prices, as well as factors summarizing real economic activity and leads of variables included in the factors (e.g. registered unemployed, unemployment rate, motor vehicle registrations, etc.).

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Comparison with previous forecasts

The forecasts for the year-on-year growth rate of real GDP presented here are less negative compared to those in the October issue. The forecasts for 2013 and 2014 are revised from -6.5% to -5.5% and from -8.0% to -5.4%, respectively. The revision is caused by the moderation of the recession during the third quarter of 2013, which is reflected in the National Accounts data for the third quarter but also in a number of indicators relating to trade and tourism. Moreover, the strengthening of economic confidence throughout the second half of 2013 and, to some extent, stabilisation tendencies in the banking sector reflected in the slight slowdown of deposit contraction in October – November also contributed to the upward revision of the projections. Economic activity and confidence in the euro area and the United Kingdom have been picking up creating a less adverse external environment for the Cypriot economy. Thus, annual GDP growth forecasts provided here are close to the central forecasts of the July issue; they are also comparable to the upper bound forecast of the October issue due to the less negative performance of a number of indicators in the third quarter that made the best-case scenario outcome more plausible.

Due to the recessionary conditions and the easing of oil prices CPI inflation projections for 2014 are revised downwards from 1.6% in the October issue to 0.7%.

3. Concluding remarks

Quarterly data available up to the third quarter of 2013 and monthly indicators released early in January 2014 are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation. Historical

relationships and recent data *currently* point to GDP growth of -5.5% and -5.4% for 2013 and 2014, respectively. Downside risks, however, are dominant at present, as the restructuring of systemic financial institutions is underway and the confidence in the banking sector is still fragile. Furthermore, downside risks are reinforced by the high levels of private sector indebtedness amidst unfavourable labour market conditions and declining incomes. CPI inflation is expected to remain subdued because of the recessionary conditions and the absence of significant upward pressures on oil prices.

Overall, the projections here indicate a contraction in real GDP of 10.9% for the period 2013–2014 compared to 12.5% forecasted in the economic adjustment programme ([1], [2]). Nevertheless, econometric models used and available data currently reveal the continuation of the recession in 2015, thus adding further to the losses. The forecasts in this bulletin remain consistent with evidence, provided in the July and October issues, of a milder recession in 2013 than that projected in the Cyprus’s programme, albeit possibly a more prolonged one as a considerable part of the adjustment costs will be incurred in 2014 or even in subsequent years.

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1. European Commission (2013), “The economic adjustment programme for Cyprus, Second review – Autumn 2013”, European Economy – Occasional Papers 169, December 2013, Directorate General – Economic and Financial Affairs.
2. International Monetary Fund (IMF) (2013), “Cyprus: Second review under the extended arrangement under the extended Fund facility and request for modification of performance criteria”, IMF Country Report No. 13/374, December 2013.
3. International Monetary Fund (2014). World Economic Outlook – Update, January 2014.

APPENDIX

Table A1: GDP growth forecasts (components of forecasts, weights and forecast by component)

| Year | CONTRIBUTION BY COMPONENT | | | | | WEIGHT | | | | | FORECAST BY COMPONENT | | | | |
|--------------------------------|---------------------------|------|------|------|------|------------------|-------|-------|-------|-------|-----------------------|------|------|------|------|
| | 2013 | | 2014 | | | 2013 | | 2014 | | | 2013 | | 2014 | | |
| Quarters | 4 | 1 | 2 | 3 | 4 | 4 | 1 | 2 | 3 | 4 | 4 | 1 | 2 | 3 | 4 |
| COMPONENTS | | | | | | | | | | | | | | | |
| Real economy | -0.1 | -0.0 | -0.0 | -0.0 | -0.0 | 1.4 | 0.5 | 0.6 | 0.6 | 0.5 | -5.5 | -4.8 | -5.2 | -7.7 | -8.2 |
| Excluding real economy | -0.0 | -0.1 | -0.1 | -0.1 | -0.1 | 1.0 | 1.4 | 1.4 | 1.9 | 1.9 | -5.0 | -5.1 | -4.8 | -5.4 | -4.8 |
| Real economy and other aspects | -5.2 | -4.8 | -4.8 | -6.0 | -5.4 | 97.6 | 98.1 | 98.0 | 97.5 | 97.5 | -5.4 | -4.9 | -4.9 | -6.2 | -5.5 |
| Fiscal | -0.1 | -0.1 | -0.1 | -0.2 | -0.2 | 1.5 | 1.1 | 2.5 | 3.2 | 3.4 | -5.3 | -4.7 | -4.6 | -6.9 | -6.7 |
| Prices | -0.2 | -0.1 | -0.2 | -0.3 | -0.3 | 3.6 | 1.8 | 4.0 | 4.6 | 4.9 | -5.2 | -4.6 | -4.9 | -7.0 | -6.3 |
| Exchange rates | -0.1 | -0.1 | -0.1 | -0.3 | -0.2 | 1.1 | 2.3 | 2.7 | 3.2 | 3.1 | -5.3 | -5.0 | -5.2 | -7.9 | -6.7 |
| Interest rates and spreads | -1.3 | -0.9 | -1.1 | -1.3 | -1.1 | 24.5 | 17.7 | 21.8 | 22.8 | 20.2 | -5.3 | -4.9 | -5.0 | -5.8 | -5.6 |
| Stock markets | -1.1 | -1.7 | -1.4 | -1.9 | -1.5 | 20.2 | 34.6 | 28.7 | 30.3 | 33.9 | -5.4 | -5.0 | -5.0 | -6.2 | -4.5 |
| Economic sentiment | -2.1 | -1.8 | -1.5 | -1.6 | -1.5 | 38.5 | 37.0 | 31.3 | 26.5 | 22.8 | -5.4 | -4.9 | -4.8 | -6.2 | -6.8 |
| Loans and deposits | -0.4 | -0.1 | -0.3 | -0.4 | -0.4 | 8.3 | 3.6 | 6.9 | 6.8 | 9.3 | -5.3 | -3.7 | -3.9 | -5.4 | -4.7 |
| | FORECAST | | | | | NUMBER OF MODELS | | | | | | | | | |
| | -5.4 | -4.9 | -4.9 | -6.1 | -5.5 | 723 | 27217 | 61459 | 51689 | 41227 | | | | | |



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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.

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