Issue 15/1

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

January 2015

UNIVERSITY OF CYPRUS

SUMMARY

Real GDP growth in Cyprus for 2014 is projected at -2.2% as the decline in real economic activity in the fourth quarter (y-o-y) is estimated at 1.4%. The recession is forecasted to persist in 2015, but the contraction of real output is estimated to decelerate considerably. Real GDP growth for 2015 is forecasted at -0.4%. Real GDP is estimated to fall by 0.8% in the first half of 2015 and to remain flat in the second half of the year.

The decline in output for the last quarter of 2014 and for 2015 is estimated to be less severe than that registered in the first three quarters of 2014. The amelioration of the recession is driven by the following: (i) the slowdown of the contraction of domestic activity and employment; (ii) stable/decreasing domestic prices coupled with declining international oil prices; (iii) the strengthening of domestic economic confidence throughout 2014 and the favourable performance of the Cyprus Stock Exchange in 2014; (iv) further strengthening of stabilisation tendencies in the banking system; and (v) external factors, such as the expansion of real activity in the euro area and the United Kingdom during the third quarter, and the weakening of the euro against the British pound, which is expected to influence positively domestic activity through tourism. Some recent developments, however, generate effects that are found to weigh on activity in Cyprus in the following quarters, hindering earlier and stronger recovery. These developments include: (i) uncertainties about the euro area recovery momentum reflected by the historically low levels of European interest rates, the decline of the EU stock market returns and the weakening of the euro against the US dollar; (ii) the slowdown of the Russian economy and the rapid depreciation of the rouble against the euro; and (iii) political and economic uncertainty in Greece captured by the negative performance of the Athens stock exchange index and the rising long-term interest rate on Greek government bonds. Domestic factors which impact negatively on the activity outlook include the elevated unemployment rate, the relatively high lending interest rates reflecting tight domestic credit conditions, the historically low levels of fixed investment, and the high levels of public debt.

Downside risks to the outlook relate to the following:

- The rising levels of non-performing loans, together with delays in the implementation of the relevant legal framework and in the effective management of such loans, could reinforce tight credit conditions with adverse effects on confidence and the real economy.
- Delays in the advancement of agreed structural reforms and, in general, weaker commitment to the implementation of the economic adjustment programme could damage economic confidence and create risks to fiscal targets and activity.
- Further slowdown of the Russian economy and depreciation of the rouble against the euro, weakening of the recovery momentum in the euro area, as well as political and economic uncertainty in Greece may also create some risks to the outlook.

Some upside risks to the outlook are also present. The accommodative monetary policy stance announced recently by the ECB is expected to improve the liquidity of the domestic banking system with positive effects on the real economy. However, eligibility for the ECB's expanded asset purchase programme is conditional on a positive review of the country's economic adjustment programme. The monetary stimulus by the ECB is expected to strengthen confidence and demand in the euro area, influencing favourably domestic activity. Robust growth in the United Kingdom combined with the weakening of the euro against the British pound could benefit tourism. Investment decisions related mainly to the tourism sector may improve the medium-term prospects of the economy.

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1. Recent developments

The recession in Cyprus moderated further in the third quarter of 2014 as real GDP declined by 1.8% year-on-year (y-o-y). The sector of professional and administrative activities returned to growth in the third quarter while trade, transport, accommodation and food services as well as real estate activities expanded only marginally. The remaining sectors contracted during the third quarter of 2014. The most severe decline of the gross value added (y-o-y) in the third quarter was registered in construction followed by financial and insurance activities. Private consumption increased (y-o-y) for a second consecutive quarter, though the decline in the final consumption expenditure accelerated in the third quarter due to the faster contraction of general government expenditure. In the third quarter gross capital formation increased (y-o-y) strongly as a result of inventory accumulation and slight growth in fixed investment; nonetheless investment still remains at historically low levels. During the third quarter, exports declined (y-o-y), while imports continued to rise (y-o-y) for a third quarter so that net exports turned negative.

The Economic Sentiment Indicator (ESI) increased weakly in the final quarter of 2014 as a result of confidence improvements in services and among consumers. In retail trade economic sentiment stalled while in construction and manufacturing confidence worsened in the fourth quarter. As shown by the Business Confidence Index, firms' activity perceptions and expectations as well as employment expectations remained practically unchanged over the second half of 2014 (Figure 1). The Consumer Confidence Indicator continued to improve during the last quarter of 2014 but at a rather slower rate compared to previous quarters (Figure 2). The recent Survey data show that confidence has broadly recovered to its pre-crisis levels signalling that the recession will continue to moderate in the short run but perhaps in a more muted fashion than in previous quarters.

The number of registered unemployed continued to decrease (y-o-y) in the last quarter of 2014 and job vacancies increased (y-o-y) in October-November; however the performance of these indicators has slightly deteriorated compared to the third quarter of 2014. The unemployment rate (Eurostat) has been rising slowly since the second quarter of 2014 reaching a new peak (16.8%) in November.

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

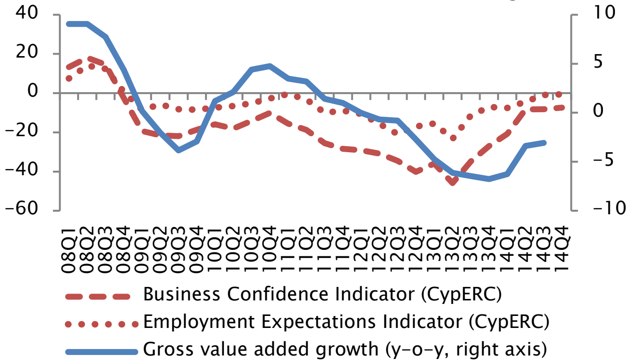
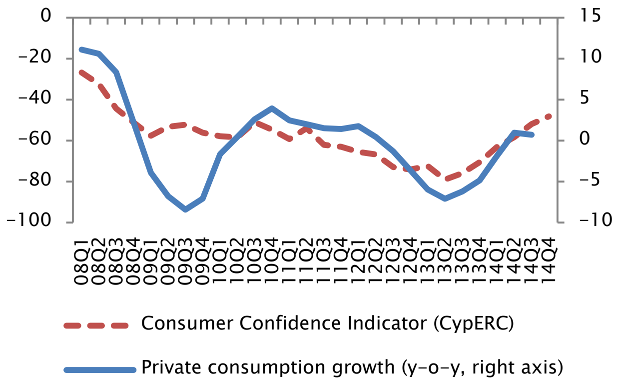


Figure 2: Consumer Confidence Indicator (CypERC) and private consumption growth



Signals from monthly leading indicators available for some or all of the months of the fourth quarter of 2014 are mixed. Some indicators such as credit card usage, registrations of motor vehicles, volume and value index of retail trade and registrations of new companies continued to grow (y-o-y). Tourist arrivals decreased (y-o-y) in the final quarter with the decline in the number of Russian tourists being particularly acute; revenue from tourism also shrank in October. Other indicators that underperformed during some or all of the months of the last quarter include cement sales, building permits, industrial production and the Cyprus stock exchange index.

The contraction of domestic credit slowed down in October-November and the loans to non-financial corporations registered weak growth in November. Deposits continued to decline but at a slower pace compared to the first half of 2014. The rate of outflow of non-EU deposits accelerated in October-November. Non-performing loans relating to local operations rose further in November reaching 49.7% of total credit facilities. Lending rates have been declining, albeit sluggishly, suggesting that challenges for the banking system remain.

According to monthly fiscal data a surplus for the general government was recorded over October-November 2014 as a result of a large decrease (y-o-y) in expenditure despite the drop (y-o-y) in revenue.

After a slowdown in deflation, measured by the Consumer Price Index (CPI), in the third quarter and in October-November, the decline of the aggregate price level accelerated in December. During the final quarter of 2014 CPI declined by 0.7% (y-o-y) as a result of decreases in the prices of housing-water-electricity-gas, transport and food. In 2014 CPI decreased by 1.4% compared to 2013 as a result of weak domestic demand and lower international oil prices.

2. Forecasts

Projections for GDP growth are constructed using quarterly data available up to the third quarter of 2014. Monthly indicators released by 9 January 2015 that contain information covering the first months of the final quarter of 2014 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 estimation.

The forecasts for the (y-o-y) growth rate of real GDP for the final quarter of 2014 as well as for the four quarters of 2015 are shown in Table 1; projections for 2014 and 2015 are also provided using the forecasted y-o-y growth rates.[1]

- Based on the historical relationships between growth and numerous macroeconomic indicators, the decline of real activity in the fourth quarter of 2014 is estimated at 1.4%; real GDP growth for 2014 as a whole is projected at -2.2%.
- The recession is forecasted to persist in 2015, but the contraction of real activity is estimated to decelerate considerably. Real GDP growth for 2015 is projected at -0.4%. Real output is forecasted to fall by 0.8% in the first half of 2015 and to remain flat in the second half of the year.

[1] The forecasts for the y-o-y growth rate of real GDP reported in the table are obtained via the estimation of a large number of alternative models embracing various aspects of the economy. The final forecast for each quarter presented here is computed as the weighted average of all model forecasts using weights based on the historical forecasting performance of each model.

Table 1 presents also 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) in shaping the final forecast. *Real economy* factors (domestic and international activity and labour market) and components in the group which *excludes real economy* factors have a minor effect on the formation of the forecast in all quarters (about 3%-4%).[2] However, *real economy factors jointly with other* components play a key role in determining the forecasts.

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

YEAR	2014	2015			
FORECAST[2]	-2.2	-0.4			
Quarter	4	1	2	3	4
FORECAST (y-o-y)	-1.4	-1.0	-0.6	-0.3	0.3
Forecast error[3]	0.8	1.6	2.4	3.5	4.1
COMPONENTS[4]					
Real economy	-0.02	-0.01	0.00	0.00	-0.01
Excluding real economy	-0.03	-0.02	0.00	0.01	0.00
Real economy & other aspects	-1.36	-0.94	-0.59	-0.35	0.28
Fiscal	-0.04	-0.02	-0.02	-0.02	0.01
Prices	-0.12	-0.07	-0.03	0.00	0.07
Exchange rates	-0.06	-0.04	-0.02	0.00	0.02
Interest rates, spreads	-0.32	-0.22	-0.13	-0.07	0.06
Stock markets	-0.29	-0.22	-0.16	-0.15	-0.02
Econ. sentiment	-0.38	-0.26	-0.16	-0.08	0.07
Loans and deposits	-0.17	-0.11	-0.06	-0.02	0.09

[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 in the computation of the final forecast. The weight of each component is determined by the inverse of the discounted mean squared forecast errors of the relevant models (i.e. forecast errors in the more distant past are discounted more heavily).
[2] For the first, second and third quarter of 2014 the y-o-y growth rates of GDP obtained from published data are used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 09/12/2014).
[3] Pseudo out-of-sample root mean squared forecast error of the forecast method.
[4] Differences between the forecasts and the sum of the components are due to rounding.

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), banking

[2] The group which excludes real economy factors includes: interest rates and spreads, stock market indicators, economic sentiment indicators, exchange rates, domestic and foreign price indices, international commodity prices, fiscal and banking-related series.

sector series (e.g. loans, deposits) as well as domestic and international prices. Real economy factors and monthly values of series contained in the factors (e.g. unemployment rate, registered unemployed, vacancies, arrivals of tourists) are also included in the models. Historically such models have been generating relatively more accurate forecasts and, therefore, have been gaining greater importance in the construction of the final forecast.

The decline in output for the last quarter of 2014 and for 2015 is estimated to be less severe than that registered in the first three quarters of 2014. The main drivers of the amelioration of the recession projected for the following quarters are discussed below.

- The contraction of domestic real economic activity and employment has been slowing down since the second half of 2013. Some activity leading indicators (e.g. volume/value index of retail trade, credit card usage, registrations of motor vehicles, registrations of new companies, number of job vacancies) continued to grow in the last quarter of 2014.
- Stable or decreasing domestic prices coupled with low foreign inflation and declining international oil prices are found to limit the depth of the recession in the last quarter of 2014 and during the first half of 2015, and to even contribute towards a small increase in activity in the second half of 2015.
- The strengthening of domestic economic confidence throughout 2014 as shown by the rising Economic Sentiment Indicator for Cyprus is estimated to influence positively domestic activity. Moreover, the positive (y-o-y) returns of the Cyprus stock exchange (general) index registered over February-October 2014 after a long and deep downturn, point to a smaller output contraction compared to that recorded in the previous quarters.
- The stabilisation tendencies in the banking system strengthened further in the second half of the year, as deposits and loans contracted at a slower pace than previously, contributing to growth in the following quarters. The normalisation of the domestic financial system is also reflected by the improvements in confidence indicators and the favourable performance of the Cyprus stock market in 2014.
- Some external factors such as the expansion of real activity in the euro area and the United Kingdom during the third quarter, and the levels of economic confidence around the long-run average registered in the European Union throughout 2014 are conducive for easing the recession in the next quarters. Moreover, the weakening of the euro against the British pound which intensified in the second half of 2014 is expected to influence positively domestic activity, especially in the second and third quarter of 2015, through effects on tourism services.

Nevertheless, some recent developments generate negative dynamics that are found to weigh on domestic activity in the following quarters, hindering earlier and stronger recovery. Growth in the euro area remained rather weak in the third quarter of 2014, inflation continued to fall in the last quarter, and uncertainties about the euro area recovery momentum are also reflected by the historically low levels of European interest rates, the decline of the European stock market returns and the weakening of the euro against the US dollar. The slowdown of the Russian economy and the rapid depreciation of the rouble against the euro are also expected to put a drag on growth in Cyprus, mainly via the tourism channel. Furthermore, political and economic uncertainties in Greece that have arisen recently are captured by the negative performance of the Athens stock exchange index and the rising long-term interest rate on Greek government bonds, impacting negatively on domestic activity in the next quarters.

On the domestic front, factors that negatively affect the outlook for activity include: the elevated unemployment rate together with some upward pressures recorded in the last months of 2014, the relatively high lending interest rates reflecting tight domestic credit conditions, the historically low levels of fixed investment, and the high levels of public debt.

Downside risks to the outlook include the following:

- The rising levels of non-performing loans together with delays in the implementation of the relevant legal framework and in the effective management of such loans, could reinforce tight credit conditions with adverse effects on confidence and the real economy.
- Delays in the advancement of agreed structural reforms and, in general, weaker commitment to the implementation of the economic adjustment programme could damage economic confidence and create risks to fiscal targets and activity.
- Further slowdown of the Russian economy and depreciation of the rouble against the euro could negatively affect international business activities and

tourism revenue in Cyprus (e.g. the IMF published a large downward revision to Russia's growth projections for 2015 [4]).

- Weakening of the recovery momentum in the euro area could adversely impact on domestic GDP (e.g. the euro area growth forecasts for 2015 were revised downwards by the ECB and the IMF ([2], [4]). Political and economic uncertainties in Greece may also create some risks to the outlook.

The accommodative monetary policy stance announced by the ECB, and in particular the expanded asset purchase programme is expected to improve the liquidity of the domestic banking system with positive effects on the real economy. However, eligibility for the programme is conditional on a positive review of the country's economic adjustment programme. The monetary stimulus by the ECB is expected to strengthen confidence and demand in the euro area, influencing favourably domestic activity. Robust growth in the United Kingdom combined with the weakening of the euro against the British pound could benefit exports, most notably tourism. Investment decisions related mainly to the tourism sector could improve the medium-term prospects of the economy.

3. Concluding remarks

Quarterly data available up to the third quarter of 2014 and monthly indicators released early in January 2015 are employed in dynamic econometric models to construct forecasts for GDP growth. The forecast for real GDP growth for the final quarter of 2014 remained unchanged from the previous issue. The upward revision to the forecast for 2014 as a whole from -2.4% in the October issue to -2.2% in this issue, resulted from the revised GDP data for the first two quarters and the slightly better than forecasted outcome for the third quarter. Real GDP growth for 2015 as a whole is projected at -0.4% as in the October issue.

The forecasts for 2015 given here suggest that activity will continue to decline, albeit at a much slower rate than in 2014. The European Commission and the Central Bank of Cyprus project weak growth at 0.4% and 0.8% respectively ([3], [1]). As the error surrounding the projections for 2015 presented here is relatively large and given the prospect of some upside risks materialising, a positive growth outcome for 2015 cannot be excluded. However, downside risks associated with external factors as well as underlying domestic weaknesses such as high private and public sector indebtedness levels, and high unemployment may undermine a sustained recovery.

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APPENDIX

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

	CONTRIBUTION BY COMPONENT					WEIGHT					FORECAST BY COMPONENT				
Year	2014	2015				2014	2015				2014	2015			
Quarters	4	1	2	3	4	4	1	2	3	4	4	1	2	3	4
COMPONENTS															
Real economy	-0.02	-0.01	0.00	0.00	-0.01	1.33	1.13	0.92	0.72	0.72	-1.4	-0.9	-0.5	-0.1	-1.0
Excluding real economy	-0.03	-0.02	0.00	0.01	0.00	2.58	2.25	1.76	1.52	1.70	-1.3	-0.7	-0.2	0.5	-0.2
Real economy and other aspects	-1.36	-0.94	-0.59	-0.35	0.28	96.09	96.62	97.32	97.76	97.58	-1.4	-1.0	-0.6	-0.4	0.3
Fiscal	-0.04	-0.02	-0.02	-0.02	0.01	2.34	2.27	2.29	2.40	2.50	-1.5	-1.1	-0.9	-0.7	0.3
Prices	-0.12	-0.07	-0.03	0.00	0.07	8.79	9.44	9.45	9.15	9.55	-1.3	-0.8	-0.4	0.0	0.7
Exchange rates	-0.06	-0.04	-0.02	0.00	0.02	4.63	4.48	4.46	4.36	4.59	-1.3	-0.8	-0.4	-0.1	0.4
Interest rates and spreads	-0.32	-0.22	-0.13	-0.07	0.06	22.12	22.90	24.03	24.22	23.58	-1.4	-1.0	-0.5	-0.3	0.2
Stock markets	-0.29	-0.22	-0.16	-0.15	-0.02	20.40	20.90	21.27	22.47	22.52	-1.4	-1.0	-0.8	-0.7	-0.1
Economic sentiment	-0.38	-0.26	-0.16	-0.08	0.07	25.14	24.48	23.78	22.98	21.96	-1.5	-1.1	-0.7	-0.4	0.3
Loans and deposits	-0.17	-0.11	-0.06	-0.02	0.09	12.67	12.15	12.04	12.17	12.88	-1.4	-0.9	-0.5	-0.2	0.7
	FORECAST					NUMBER OF MODELS									
	-1.4	-1.0	-0.6	-0.3	0.3	27356	27356	27356	27356	27356					

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