



Issue 15/2

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

April 2015

SUMMARY

The recession is forecasted to persist in 2015, but the contraction of real activity is estimated to decelerate especially in the second half of the year. Real GDP growth for 2015 is projected at -0.9%. Real output is forecasted to fall (y-o-y) by 1.7% and 1.2% in the first and second quarter respectively. A further decline in real GDP is estimated for the third and final quarter of 2015 with the corresponding forecasts at -0.5% and -0.1%.

The decrease in output for 2015 is estimated to be less severe than that registered in 2014. The moderation of the recession is driven by the following: (i) the slowdown of the contraction of domestic activity and employment, despite a setback recorded in recent months; (ii) decreasing domestic prices and low foreign inflation driven by subdued demand and declining international oil prices; (iii) the expansion of real activity in the EU and the euro area in the final quarter of 2014, and expectations about stronger growth in the euro area; (iv) improvements in domestic economic confidence; (v) the weakening of the euro against the British pound, which positively influences domestic activity through tourism.

Nevertheless, the following factors are found to weigh on domestic activity in the next quarters, hindering earlier and stronger recovery:

- the weak performance of the European financial markets in the final quarter of 2014 reflected uncertainties about the euro area recovery momentum – such uncertainties have been diminishing in view of the recently announced accommodative monetary stance, the weakening euro and falling oil prices leading to improved euro area outlook;
- the economic uncertainty in Greece about a funding agreement is captured by the rising long-term interest rate on Greek government bonds and by the sliding Athens stock exchange index with negative effects on the Cyprus stock market and activity;
- the economic downturn in Russia and the faster depreciation of the rouble against the euro in the last two quarters put a negative pressure on domestic GDP growth; and
- the high indebtedness levels and the limited amounts of fresh credit combined with deleveraging put a drag on domestic activity in subsequent quarters.

Downside risks to the outlook include the following: the deepening of the recession in the Russian economy and further depreciation of the rouble against the euro; the economic uncertainty regarding a new funding agreement for Greece which could have a direct negative impact on the Cyprus economy and create indirect pressures through a possible new crisis in the euro area; the high levels of non-performing loans together with complications in the implementation of the relevant legal framework, and delays in the advancement of structural reforms agreed in the economic adjustment programme.

Upside risks to the outlook include: the accommodative monetary policy stance announced by the ECB which is expected to improve the liquidity of the domestic banking system (when Cyprus becomes eligible for participation in the programme); improved euro area growth prospects; robust growth in the UK combined with the weakening of the euro against the British pound – which could benefit exports; investment decisions linked mainly to the tourism or energy sector as well as public investment efforts to expand existing infrastructure, which may improve the medium-term prospects of the economy.

In spite of the prospect of some upside risks materialising, the GDP growth forecast given here may incorporate some downside risks associated with external developments through leading indicators (exchange rates, stock market indices, interest rates); it also reflects some underlying domestic weaknesses such as high private and public sector indebtedness levels, and elevated unemployment, which are found to delay recovery. Nevertheless, the econometric analysis based on the currently available data suggests that growth in the Cyprus economy will resume in 2016 supported by lower energy prices, weaker euro and improved economic sentiment, especially in services.



April 2015

1. Recent developments

The recession in Cyprus during the final quarter of 2014 persisted at same rate as in the third quarter as real GDP declined by 2.0% year-on-year (y-o-y). In the fourth quarter, the sector of professional and administrative activities grew more strongly compared to the two previous quarters while real estate activities expanded only marginally. The remaining sectors continued to contract in the fourth quarter of 2014. The decline of the gross value added (y-o-y) in the sectors of construction, manufacturing, trade, transport, accommodation and food services accelerated in the final quarter. Private consumption growth (y-o-y) accelerated in the last quarter but final consumption expenditure continued to decrease due to the contraction of the general government expenditure. In the fourth quarter gross capital formation registered a double-digit decline (y-o-y) as a result of a large drop in fixed investment. During the fourth quarter, exports grew (y-o-y) faster than imports resulting in a positive contribution to domestic output.

The Economic Sentiment Indicator (ESI) increased further in the first quarter of 2015 as a result of confidence improvements in all sectors; nevertheless only the services sector exhibited an uninterrupted rise in sentiment throughout 2014 and in the first quarter of 2015.

The Business Confidence and Employment Expectations Indicators increased slightly in the first quarter of 2015 reflecting firms' less pessimistic views about their activity and employment in the short run compared to previous quarters (Figure 1). The Consumer Confidence Indicator (CypERC) continued to improve albeit at a diminishing rate (Figure 2). Thus the evolution of Survey indicators suggests that the recession will continue to moderate in the following quarters but in a rather muted mode.

The number of registered unemployed continued to decrease (y-o-y) in January-February but at a slower pace compared to the last quarter of 2014; job vacancies in December increased (y-o-y) at a much smaller rate compared to previous months and the decline (y-o-y) in employment accelerated during the final quarter of 2014. The unemployment rate (Eurostat) in the fourth quarter stood at 16.4% and above the rates recorded in the first three quarters of 2014; however, it has been receding slowly since November when it reached its highest level for 2014.

In January-February some domestic leading indicators, such as credit card usage, cement sales, registrations of motor

vehicles, registrations of new companies and the Cyprus stock exchange index, performed worse than in the final quarter of 2014. Tourist arrivals increased (y-o-y) in January-February against the unfavourable picture of the previous two quarters.

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

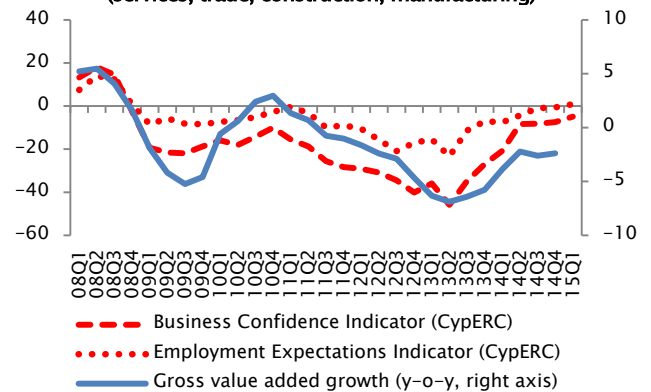
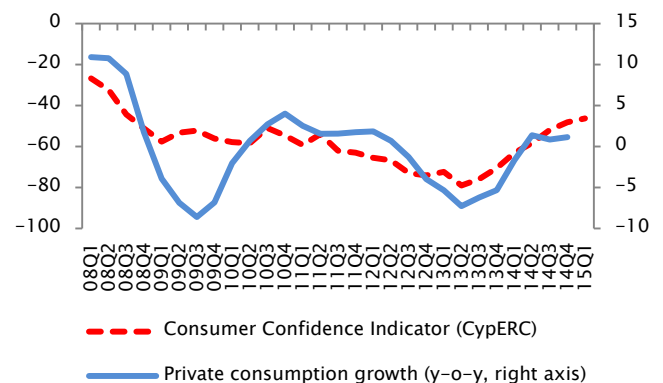


Figure 2: Consumer Confidence Indicator (CypERC) and private consumption growth



The contraction of the stock of loans decelerated further in the last quarter of 2014 and in January-February; credit to domestic residents, most notably the loans to non-financial corporations registered weak growth in January-February. The reduction of domestic deposits slowed down in January-February; however the rate of outflow of non-EU deposits accelerated over the same period.

Deflation accelerated in the first quarter of 2015 as the Consumer Price Index (CPI) fell (y-o-y) by 1.5% compared to -0.7% in the final quarter of 2014. The decline in the aggregate price level which was the result of lower international oil prices and weak domestic demand, was driven by reductions in the prices of housing-water-electricity-gas, transport, education and recreation-culture.

April 2015

2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the fourth quarter of 2014. Monthly indicators released by 20 March 2015 that contain information covering at most the first three months of 2015 are also used. All forecasts presented in this bulletin are based solely on published data; thus, they only incorporate effects already captured by the quarterly series and the monthly leading indicators used in estimation.

The forecasts for the (y-o-y) growth rate of real GDP for the four quarters of 2015 are shown in Table 1; a projection for the whole of 2015 is also provided using the forecasted y-o-y growth rates.¹

- Based on the historical relationships between growth and numerous macroeconomic indicators, the recession is forecasted to persist in 2015, but the contraction of real activity is estimated to decelerate especially in the second half of the year.
- Real GDP growth for 2015 is projected at -0.9%. Real output is forecasted to fall by 1.7% and 1.2% in the first and second quarter of 2015 respectively. A further decline in real GDP is estimated for the third and final quarter of 2015 with the corresponding forecasts at -0.5% and -0.1%.

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%).² However, *real economy factors jointly with other* components play a key role in determining the forecasts.

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 average of forecasts from models with better historical forecasting performance than that of a simple model.

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, as well as fiscal and banking sector related series.

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

YEAR	2015			
FORECAST ²	-0.9			
Quarter	1	2	3	4
FORECAST (y-o-y)	-1.7	-1.2	-0.5	-0.1
Forecast error ²	0.9	1.6	2.3	3.2
COMPONENTS³				
<i>Real economy</i>	-0.01	-0.01	0.00	0.00
<i>Excluding real economy</i>	-0.04	-0.03	0.00	0.01
<i>Real economy & other aspects</i>	-1.60	-1.13	-0.53	-0.09
Fiscal	-0.06	-0.05	-0.02	0.00
Prices	-0.09	-0.06	-0.01	0.01
Exchange rates	-0.08	-0.05	-0.02	-0.01
Interest rates, spreads	-0.37	-0.29	-0.12	0.05
Stock markets	-0.37	-0.24	-0.13	-0.04
Econ. sentiment	-0.42	-0.29	-0.14	-0.04
Loans and deposits	-0.20	-0.15	-0.09	-0.03

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.

The forecasts in all quarters are mainly formed by models that include (one at a time) interest rates, spreads, economic sentiment indicators, stock market indices, banking sector series (e.g. loans, deposits), domestic or foreign/international prices. Real economy factors and monthly values of series contained in the factors (e.g. unemployment rate, registered unemployed, registrations of motor vehicles, arrivals of tourists) are also included in the models. Historically such models have been generating relatively more accurate forecasts than other groups of models and therefore have been gaining greater importance in the construction of the final forecasts.

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

- The contraction of domestic real economic activity and employment has been decelerating since the third quarter of 2013. However, in the second half of 2014 a slight worsening of the recession was recorded, and employment declined faster in final compared to the third quarter. Activity-related leading indicators (e.g.



April 2015

credit card usage, registrations of motor vehicles, registered unemployed, arrivals of tourists) for January–February exhibited a rather muted improvement.

- Decreasing domestic prices and low foreign inflation driven by subdued demand and declining international oil prices are found to limit the depth of the recession after the first quarter of 2015, and to even contribute positively in activity growth towards the end of 2015.
- The EU and the euro area continued to grow in the final quarter of 2014 creating a less adverse external environment for Cyprus. Moreover, further declines in European interest rates and in the borrowing costs of most euro area countries, reflecting the accommodative monetary policy stance recently announced by the ECB and expectations about stronger growth in the euro area, are found to benefit domestic activity, especially in the second half of 2015.
- The domestic economic confidence returned to its pre-crisis levels and the Economic Sentiment Indicator for the EU and the euro area stands above its long-run average, suggesting improved growth prospects. Thus the recent developments in domestic and European economic sentiment are expected to influence positively domestic activity. Nevertheless, the presence of adverse real economy conditions (e.g. elevated unemployment rate, weak demand especially for investment) dampens the favourable effects of boosted confidence on output.
- The weakening of the euro against the British pound that accelerated after the first half of 2014 is expected to positively influence domestic activity in the second and third quarter through its effects on exports, in particular tourism services.

Some factors that are found to weigh on domestic activity in the following quarters, hindering earlier and stronger recovery are discussed below.

The decline in the returns of the European stock markets in the final quarter of 2014 as well as the negative performance of the Athens and Cyprus stock exchange index from the fourth quarter of 2014 onwards weighs on the outlook. The weak performance of the European financial markets in the final quarter of 2014 reflected uncertainties about the euro area recovery momentum which seem to be diminishing as growth prospects have improved. The lower oil prices, the depreciation of the euro which supports euro area exports, and the expected positive effects of the ECB's expanded asset purchase programme

on demand are conducive to stronger growth in the euro area. The improved euro area outlook is reflected in the higher stock market returns recorded in the first quarter of 2015 and therefore the negative effects of the past underperformance on domestic activity is likely to be short-lived. The economic uncertainty in Greece about a funding agreement is captured by the declining Athens stock exchange index with negative effects on the Cyprus stock market and activity. The recent economic distress in Greece, also mirrored by the rising long-term interest rate on Greek government bonds, exerts additional negative pressure on the Cyprus economy due to the links between the two countries.

Another external factor that weighs on the outlook for the Cyprus economy is the economic downturn in Russia largely due to the decrease in oil prices and the economic sanctions, leading to the depreciation of the rouble. The weakening of the rouble against the euro that accelerated in the final quarter of 2014 and in the first quarter of 2015 is found to negatively affect domestic GDP growth through mainly tourism, especially in the second half of 2015.

The stabilisation of the banking system has been progressing as deposits and loans have been contracting at a slower pace in recent months. Nevertheless the high indebtedness levels and the limited amounts of fresh credit combined with deleveraging put a drag on domestic activity in subsequent quarters. Furthermore, the favourable impact of small declines in domestic interest rates in the past few months is weakened by the adverse conditions in the real economy.

The downside and upside risks to the outlook have remained broadly unchanged from the previous issue. Downside risks to the outlook include the following:

- The deepening of the recession in the Russian economy and the acceleration of rouble depreciation against the euro are likely to put additional negative pressures on tourism revenue and international business activities in Cyprus (e.g. the European Commission projected a large contraction in Russia's real GDP for 2015 [2]).
- The economic uncertainty regarding a new funding agreement for Greece could have a direct negative impact on the Cyprus economy and create indirect pressures through a possible new sovereign debt crisis that could threaten the recovery of the euro area.



April 2015

- The high levels of non-performing loans together with complications in the implementation of the relevant legal framework and in the effective management of such loans, could worsen credit conditions with adverse effects on Cyprus's credibility, 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.

Upside risks to the outlook are also present. The accommodative monetary policy stance announced 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 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. Moreover improved euro area growth prospects as a result of lower oil prices and the depreciation of the euro leading to stronger external demand, create upside risks to domestic outlook (ECB revised upwards the euro area growth projection for 2015 [1]). 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 linked mainly to the tourism or energy sector, and public investment efforts to expand existing infrastructure could improve the medium-term prospects of the economy.

CPI inflation in 2015 is projected at -0.9%.³ The negative inflation projection for 2015 is driven by the decelerating or negative rates of change in domestic price indices in the previous quarters, weak domestic demand, low foreign inflation rates, and declining international oil and non-energy commodity prices.

Upside risks relate to increases in international commodity prices and further weakening of the euro. Downside risks to the projection stem from the recessionary conditions in the

economy, which are forecasted to continue throughout 2015, as well as from weak external demand.

3. Concluding remarks

Quarterly data available up to the fourth quarter of 2015 and monthly indicators released between January and mid-March 2015 are employed in dynamic econometric models to construct forecasts for GDP growth and CPI inflation.

The forecast for real GDP growth for 2015 is revised from -0.4% in the January to -0.9%. The downward revision to the forecast for 2015 resulted from the revised GDP data especially for the first three quarters of 2014 and the worse than forecasted outcome for the final quarter of 2014, resulting in a setback in the recession moderation after the second quarter. Adverse external developments in the first quarter of 2015 such as the faster depreciation of the rouble against the euro and the economic instability in Greece also influenced the downward revision.

The forecast for CPI inflation for 2015 is revised from 1.0% in the October issue to -0.9% mainly as a result of declining international oil prices and subdued domestic demand which is projected to persist throughout the year.

The forecasts for 2015 given here suggest that activity will continue to decline, albeit at a much slower rate than that in 2014. The European Commission projects weak growth at 0.4% ([1]). In spite of the prospect of some upside risks materialising, the GDP growth forecast given here may incorporate some downside risks associated with external developments through leading indicators such as exchange rates, stock market indices, interest rates and spreads. Furthermore, the 2015 growth forecast reflects some underlying domestic weaknesses such as high private and public sector indebtedness levels, and elevated unemployment that are found to delay recovery. Nevertheless, the econometric analysis based on the currently available data suggests that growth in the Cyprus economy will resume in 2016 supported by lower energy prices, weaker euro and improved economic sentiment especially in the services sector.

REFERENCES

1. European Central Bank (ECB) (2015), "March 2015 ECB Staff Macroeconomic Projections for the Euro Area", March 2015.
2. European Commission (2015), "European Economic Forecast - Winter 2015", European Economy 1/2015.

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 and 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.).

April 2015

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	2015				2015				2015			
Quarter	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
Real economy	-0.01	-0.01	0.00	0.00	0.75	0.77	0.78	0.78	-1.60	-1.13	-0.44	0.01
Excluding real economy	-0.04	-0.03	0.00	0.01	2.41	2.42	2.41	2.43	-1.50	-1.07	-0.12	0.37
Real economy & other aspects	-1.60	-1.13	-0.53	-0.09	96.85	96.82	96.83	96.82	-1.65	-1.16	-0.55	-0.09
Fiscal	-0.06	-0.05	-0.02	0.00	3.35	3.87	3.89	3.88	-1.66	-1.17	-0.58	-0.10
Prices	-0.09	-0.06	-0.01	0.01	5.24	6.20	6.15	6.21	-1.75	-1.03	-0.24	0.09
Exchange rates	-0.08	-0.05	-0.02	-0.01	4.21	4.65	4.67	4.66	-1.83	-0.97	-0.50	-0.30
Interest rates, spreads	-0.37	-0.29	-0.12	0.05	23.89	25.53	25.62	25.50	-1.56	-1.12	-0.45	0.19
Stock markets	-0.37	-0.24	-0.13	-0.04	22.07	19.37	19.46	19.42	-1.69	-1.25	-0.65	-0.23
Economic sentiment	-0.42	-0.29	-0.14	-0.04	25.69	24.02	24.13	24.08	-1.65	-1.21	-0.59	-0.18
Loans and deposits	-0.20	-0.15	-0.09	-0.03	12.40	13.17	12.91	13.06	-1.64	-1.16	-0.70	-0.26
FORECAST					NUMBER OF MODELS							
	-1.7	-1.2	-0.5	-0.1	8765	10323	10278	10299				



Issue 15/2

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

April 2015

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.

The "Economic Outlook" publishes the results of research in the Forecasting Sector of CypERC. The views expressed in this bulletin do not necessarily reflect either those of the Academic Advisors of the Forecasting Sector or those of the CypERC Council.

Forecasting Sector at CypERC

Director:	Prof. Panos Pashardes
Research Coordinator:	Nicoletta Pashourtidou
Academic Advisors:	Assoc. Prof. Elena Andreou Assoc. Prof. Andros Kourtellos
Research Officers:	Christos Papamichael Charalampos Karagiannakis

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

Economics Research Centre, University of Cyprus, P.O. box 20537, 1678 Nicosia, CYPRUS
Telephone: 22893660, Fax: 22895027, Website: www.erc.ucy.ac.cy, Email: erc@ucy.ac.cy