



Issue 14/2

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

May 2014

SUMMARY

The recession in 2014 is forecasted to moderate compared to 2013. Real GDP growth for 2014 is projected at -3.4%. During the first quarter of 2014 real GDP is estimated to contract (y-o-y) by 4.0%; in the second and third quarter real activity is forecasted to also decline by 2.7% and 3.2%, respectively. In the final quarter of 2014 recession is projected to accelerate compared to the previous two quarters as real GDP growth is estimated at -3.8%.

The forecasted moderation of the recession in 2014 is driven by the slowdown in output contraction in Cyprus and the improvement of external real economy conditions in the final quarter of 2013. Domestic leading indicators associated with the real economy continued to improve over the first months of 2014, resulting in less negative forecasts compared to those reported in the previous issue of this bulletin. Other recent developments in the economy that have contributed to more favourable projections include: (i) the strengthening of economic confidence in Cyprus and the euro area, (ii) the improved performance of international stock markets and the pickup of the Cyprus stock exchange index, (iii) the reduction in some domestic lending interest rates and the decline in the spreads of European periphery countries, mainly that of Greece. The slowdown of the deposit contraction in the final quarter of 2013 and ongoing deleveraging also appear to play a role in shaping the current projections for 2014.

The forecasts, however, are accompanied by considerable downside risks, most notably those related to the stabilisation process of the financial system in conditions of declining output, high unemployment, and large private and public debt burdens. In particular:

- A prolonged period of tight financial conditions may have long-term effects on investment, employment and growth as well as on the rates of non-performing loans given the adverse real economy conditions.
- Failure of the financial institutions to adopt effective strategies to manage the rising rates of non-performing loans could result in additional capital needs.
- Failure of the state to shape an up-to-date and functional legal framework on debt enforcement, restructuring and insolvency, could undermine the fragile confidence in the banking sector, thereby, impacting negatively on domestic activity.

Other downside risks relate to the following:

- Possible escalation of the crisis in Ukraine followed by new EU sanctions on Russia may affect negatively international business activities and tourism revenues in Cyprus.
- Delays in the advancement of agreed structural reforms could damage consumer, business and investor confidence and create risks to fiscal targets and economic activity.

Upside risks to the outlook are mainly linked to investment decisions associated with energy and tourism sectors, and stronger growth in the United Kingdom and the euro area.

CPI inflation in 2014 is projected at slightly negative levels (-0.9%) mainly because of the recessionary conditions and the absence of significant upward pressures on international oil prices. However, data on price expectations currently point to only a limited risk of prolonged deflation.

The projections here suggest a milder contraction in real GDP for 2014 compared to the -4.8% forecasted in the economic adjustment programme. Nevertheless, the econometric analysis based on the currently available data suggests that the recession is likely to persist in 2015, indicating that the adjustment of the economy may take longer to complete.

UNIVERSITY OF CYPRUS



May 2014

1. Recent developments

In the last quarter of 2013 the Cypriot economy contracted for tenth consecutive quarter as real GDP declined by 5.0% year-on-year (y-o-y). The contraction in real output during the fourth quarter was less severe compared to the previous two, containing the fall in annual GDP in 2013 to 5.4%. All sectors except real estate activities registered negative growth rates in the final quarter of 2013. Economic activity shrank faster relative to the third quarter in the sectors of construction, manufacturing and information and communication; financial and insurance activities registered a double-digit y-o-y decline for a second quarter. During the fourth quarter, the decrease in consumption accelerated as a result of a sizeable reduction in government spending; while the contraction in gross capital formation decelerated considerably due to accumulation of inventories. Fixed investment, however, continued to shrink at unprecedented rates. Net exports remained positive due to the double-digit fall in imports vis-à-vis a much smaller drop in exports.

Since May 2013 the Economic Sentiment Indicator has been rising steadily as confidence has been building up primarily in services, retail trade and manufacturing; and to a lesser degree in construction and among consumers. Firms' activity perceptions and expectations have been picking up after they troughed in the second quarter of 2013; however the improvement in firms' employment expectations faltered in the first quarter of 2014 (Figure 1). The Consumer Confidence Indicator has also been increasing since the third quarter of 2013 suggesting a deceleration in the private consumption decline in the short run (Figure 2).

The unemployment rate (Eurostat) peaked at 16.9% in December 2013 and fell slightly to 16.6% in January-February as the number of registered unemployed in the first quarter 2014 grew at a slower rate than in the previous quarter. Moreover, recent data show that the number of vacancies has been declining at smaller rates since November 2013.

Data for the first months of 2014 show that leading indicators are still underperforming; nevertheless indicators relating to credit card usage, industrial production, registration of motor vehicles and the Cyprus stock exchange have been gradually picking up from the historical lows reached in previous quarters. Tourist arrivals in the first quarter of the year decreased compared to the same period in 2013 because of the large drop registered in UK arrivals; arrivals from Russia associated with relatively high per capita

spending increased at a much slower rate compared to previous quarters. Other indicators such as cement sales, building permits (number) and registration of new companies, appear to have passed their troughs, but they still remain severely depressed.

The contraction of loans (y-o-y) accelerated further in the first months of 2014 manifesting the shortage of liquidity in the domestic banking system; and, to some extent, the ongoing deleveraging. Although there are signs of moderation relative to September-December 2013, deposits in January-February continued to fall reflecting tendencies of households to use their buffers for consumption smoothing and repayment of loans. In January non-performing loans (as a percentage of total credit facilities) peaked at 41.7% and 47.5% for banks and the cooperative sector, respectively.

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

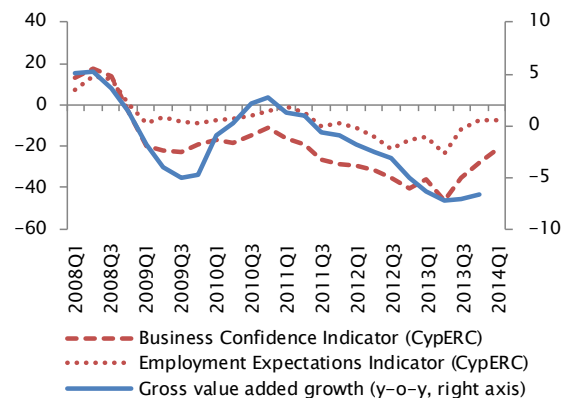
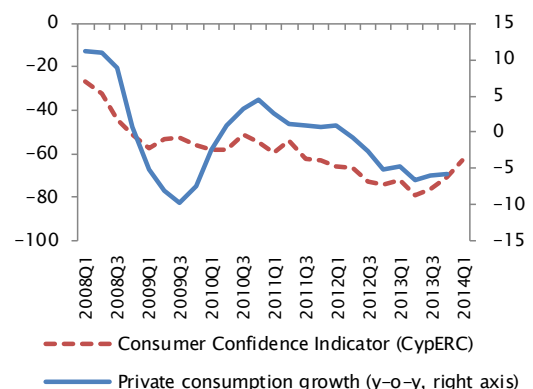


Figure 2: Consumer Confidence Indicator (CypERC) and private consumption growth



Inflation as measured by the Consumer Price Index (CPI) remained in negative territory during the first quarter of 2014, at -2.6% (y-o-y) as a result of weak domestic activity

May 2014

and subdued energy price inflation – combined with the strengthening of the euro against the US dollar in the last two quarters. The negative inflation is associated with price reductions in the categories of housing, water and energy, education, health and food.

2. Forecasts

Projections for GDP growth and CPI inflation for 2014 are constructed using quarterly data available up to the fourth quarter of 2013. Monthly indicators released by 14 April 2014 that contain information covering the first months 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 four quarters of 2014 are shown in Table 1.¹

- Based on the historical relationships between growth and numerous macroeconomic indicators, recession in 2014 is forecasted to moderate compared to 2013. Real GDP growth for the whole of 2014 is projected at -3.4%.
- During the first quarter of 2014 real GDP is estimated to contract by 4.0%; in the second and third quarter real activity is forecasted to decline by 2.7% and 3.2%, respectively. In the final quarter of 2014 recession is projected to accelerate compared to the previous two quarters, as real GDP growth is estimated at -3.8%.

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 which *excludes real economy* factors have a minor effect on the formation of the forecast in all quarters (about 3%).² However, *real economy jointly with other* components plays 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 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.

Table 1: Contribution of components to y-o-y GDP growth forecasts¹

Year	2014			
Quarter	1	2	3	4
FORECAST	-4.0	-2.7	-3.2	-3.8
COMPONENTS²				
<i>Real economy</i>	-0.04	-0.02	-0.03	-0.03
<i>Excluding real economy</i>	-0.10	-0.05	-0.05	-0.06
<i>Real economy & other aspects</i>	-3.87	-2.62	-3.09	-3.72
Fiscal	-0.15	-0.09	-0.11	-0.13
Prices	-0.29	-0.17	-0.21	-0.26
Exchange rates	-0.16	-0.13	-0.15	-0.20
Interest rates and spreads	-0.99	-0.64	-0.72	-0.91
Stock markets	-0.71	-0.55	-0.67	-0.78
Economic sentiment	-0.99	-0.68	-0.84	-1.02
Loans and deposits	-0.58	-0.36	-0.39	-0.41

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. In recent quarters the weight of forecasts from models associated with banking sector series (e.g. loans, deposits, reserves) has been increasing; currently these models contribute over 13% to the shaping of final forecasts.

Output decline in 2014 is estimated as less severe than that registered in the previous quarters, as recession in Cyprus during the final quarter of 2013 moderated and external environment improved further. In particular:

- The contraction in real economic activity has been slowing down since the third quarter of 2013. The signs of improvement exhibited by other indicators relating to domestic real economy (e.g. registered unemployed, credit card usage, and registration of motor vehicles) in the last quarter of 2013 continued in the first months of 2014, limiting the depth of the recession estimated for 2014.



May 2014

- External environment has become more favourable and therefore contributing to less negative growth projections. In the last quarter of 2013 euro area GDP growth turned positive while recession in Greece moderated. In the first months of 2014 the unemployment rate in the euro area remained stable. Furthermore activity growth in the UK and Russia strengthened in the final quarter of 2013.

Aspects of the domestic and foreign economy, which alone or in combination with real economy factors project deceleration in output contraction in 2014, are discussed below.

- International stock market indices registered high positive returns (y-o-y) in 2013, compared to very low or negative returns, in 2012. In spite of some slowdown in returns international stock markets continued the upturn in the first months of 2014. The Cyprus stock exchange (general) index is also picking up; it registered positive double-digit returns (y-o-y) in the first quarter of the year for the first time since 2010.
- Economic confidence in the European Union and the euro area has been strengthening as indicated by the Economic Sentiment Indicators, which have been rising throughout the second half of 2013 and in the first months of 2014. The Economic Sentiment Indicator for Cyprus has been gradually rebounding reflecting confidence recovery mainly in services, retail trade and to a smaller degree in manufacturing.
- Fiscal performance in the past few quarters, driven by policies that curb government deficit, signal smaller output contraction – but only towards the end of the forecast horizon.
- The decline in the spreads of European countries in the periphery, especially those of Greece, can be viewed as having an indirect positive effect on domestic activity, albeit, short-lived. The reductions in some domestic lending interest rates observed in recent months are found to ameliorate to some extent the recession in 2014.
- The considerable deceleration in the quarter-on-quarter (q-o-q) reduction in deposits registered in the fourth quarter of 2013 seems to contain the effects of the downturn, as part of the domestic deposit outflows is used for loan repayments and consumption smoothing. The decline in the stock of loans associated with deleveraging contributes towards the adjustment of the economy to lower (and more sustainable) indebtedness levels, and does not yet appear to weigh on *short-term* growth. On the other hand, to the extent

that the drop in loans lowers investment, negative growth effects are expected to arise from this channel in the medium to longer term.

Despite the less negative performance of real economy in recent quarters, domestic labour market conditions look rather bleak as unemployment remains high and investment continues to shrink at a fast pace, putting a drag on activity. Thus improvements in domestic and European economic sentiment and spreads appear to contain the recession only in the next couple of quarters; towards the end of the horizon such improvements are dominated by the adverse real economy conditions, whose effects are more persistent.

The weakening of the Russian rouble against the euro due to the developments in Russia and Ukraine are found to weigh on activity, especially in the second half of the year, through the external trade channel, most notably tourism.

Forecasts are constructed using econometric techniques, 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.

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

Quarters	2014				
	1	2	3	4	1-4
Forecast	-4.0	-2.7	-3.2	-3.8	-3.4
<i>Forecast range¹</i>					
Min	-4.6	-3.8	-4.9	-6.6	-5.0
Max	-3.4	-1.6	-1.4	-1.1	-1.9

¹ The ranges are computed as \pm root mean squared forecast error around the forecasts which correspond to 68% confidence intervals.

The quarterly profiles of the forecasts suggest that the Cyprus economy will continue incurring adjustment costs throughout 2014 but at smaller rates compared to those registered in 2013. Furthermore, recession in 2014 is estimated to be less severe than the projections in the macroeconomic scenario of the Cyprus's economic adjustment programme ([1], [2]).

Some of the downside risks which relate to the domestic financial sector and external environment that were accompanying previous forecasts persist throughout the current forecast horizon. Downside risks relating to new fiscal consolidation measures seem to have diminished for 2014 due to the recent fiscal performance; and given the real GDP growth projections computed here. Downside risks which remain relate to the following:



May 2014

- A prolonged period of limited credit supply and liquidity in the banking system could have both short- and long-term negative effects on investment, employment and growth.
- The current tight financial conditions (limited liquidity/credit, relatively high interest rates,) 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. slowdown of the q-o-q decline in deposits), confidence in the financial sector is still vulnerable. If financial institutions fail to adopt effective strategies to manage rising non-performing loans rates, the need for additional capital could arise. Moreover, failure of the state to shape an up-to-date and functional legal framework on debt enforcement, restructuring and insolvency, could undermine fragile confidence in the banking sector impacting negatively on domestic activity.
- Escalation of the crisis in Ukraine could result in European Union levying new sanctions on Russia posing risks to the outlook. Sanctions could affect negatively international business activities and tourism revenues both directly and indirectly, through further weakening of the rouble against the euro and subdued external demand (e.g. IMF revised Russia's growth forecasts for 2014 downwards [3]).
- Delays in the advancement of agreed structural reforms could damage consumer, business and investor confidence and create risks to fiscal targets and economic activity.

Upside risks to the outlook relate to the following:

- Investment decisions directly or indirectly linked to the sectors of energy and tourism could initially strengthen further economic confidence, and subsequently improve growth prospects.
- Stronger growth in the euro area and the United Kingdom is conducive to an improved export performance in Cyprus, especially tourism (e.g. IMF's growth forecasts for 2014 for the euro area and the United Kingdom have been revised upwards [3]).

- Effective absorption of European funds (e.g. structural and youth employment initiative funds) could alleviate to some degree the contractionary effects.

CPI inflation in 2014 is projected at -0.9% .³ The negative inflation projection for 2014 is driven by the declining or negative rates of change in domestic price indices in 2013 and in the first months of 2014, by low foreign inflation rates and the easing of international oil and non-energy commodity prices in combination with the strengthening of the euro against the US dollar from the second half of 2013 onwards. Moreover, weak domestic demand and high unemployment exert downward pressures on the price level.

Upside risks relate to increases in international commodity prices and the weakening of the euro against the US dollar. Downside risks to the projection stem from the recessionary conditions in the economy, which are forecasted to continue throughout 2014.

Disinflation recorded in 2012 and negative inflation rates registered after the first quarter of 2013 can be viewed as reflecting necessary corrections leading to improvements in competitiveness, as well as the resilience of various sectors that prevented the economy from slipping into a deeper recession. Nevertheless, to the extent that persistent negative inflation lowers long-term inflation expectations, or creates deflationary expectations, it could lead to deferred spending by economic agents and higher real debt burdens reinforcing recessionary conditions.

Data on the evolution of price expectations among consumers and firms in retail trade and services reveal that after bottoming out in the second quarter of 2013 they have been picking up, albeit, at a slow pace. Price expectations, however, remain in negative territory indicating that more consumers anticipate price stability/decline in the next 12 months, and more firms plan price reductions in the next 3 months compared to those (consumers or firms) who expect price increases. Given the short-term nature of price expectations registered in survey data and the upward

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, indicators relating to other aspects of the economy (e.g. exchange rates, interest rates, stock market and economic sentiment indicators) 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.).



May 2014

adaptation of price expectations from the third quarter of 2013 onwards, it appears that the effects on long-term inflation expectations are limited at the moment.

Comparison with previous forecasts

The forecasts for the year-on-year growth rate of real GDP presented in this bulletin are less negative compared to those in the January issue. The forecast for 2014 is revised from -5.4% to -3.4%. The revision is driven by the moderation of the recession in Cyprus for a second consecutive quarter and the improvement of external real economy conditions in the final quarter of 2013. Domestic leading indicators associated with the real economy (e.g. registered unemployed, registration of motor vehicles, credit card usage) continued to improve over the first months of 2014, adding to the less negative forecasts compared to the previous issue. Other economic developments that contributed to the upward revision include: (i) the strengthening of economic confidence in Cyprus and the euro area, (ii) the favourable performance of international stock markets and the pickup of the Cyprus stock exchange index after November 2013, (iii) the reduction in some domestic lending interest rates and the decline in the spread of European periphery countries, mainly that of Greece. The slowdown of the deposit contraction (q-o-q) in the final quarter of 2013 and ongoing deleveraging (to the extent that it is captured by the reduction in the stock of loans) played a role in shaping the current forecasts.

Due to weak demand conditions in Cyprus and the absence of upward pressures in international oil and non-energy commodity prices, the CPI inflation projection for 2014 is revised downwards from 0.7% in the January issue to -0.9%.

3. Concluding remarks

Quarterly data available up to the final quarter of 2013 and monthly indicators released early in April 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 -3.4% for 2014. The forecast, however, is accompanied by considerable downside risks most notably those related to the stabilisation process of the financial system in conditions of declining output, high unemployment, large private and public debt burdens. CPI inflation is projected to slip into negative territory for 2014 mainly because of the recessionary conditions and the absence of significant upward pressures on oil prices.

The projections here indicate a milder recession for 2014 compared to the contraction in real GDP of -4.8% forecasted in the economic adjustment programme ([1], [2]). Nevertheless, the econometric models used and currently available data suggest that the recession is likely to persist in 2015, with the programme's projection of growth at 0.9% for 2015 being close to the upper end but outside the 68% forecast confidence interval. Thus at this point there are indications that the adjustment of the economy will continue beyond 2014.

REFERENCES

1. European Commission (2014), "The economic adjustment programme for Cyprus, Third review - Winter 2014", European Economy - Occasional Papers 189, Directorate General - Economic and Financial Affairs.
2. International Monetary Fund (IMF) (2014), "Cyprus: Third review under the extended arrangement under the extended Fund facility and request for modification of performance criteria", IMF Country Report No. 14/92.
3. International Monetary Fund (2014). World Economic Outlook - Recovery Strengthens, Remains Uneven (Washington, April 2014).

APPENDIX

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

Year	CONTRIBUTION BY COMPONENT				WEIGHT				FORECAST BY COMPONENT			
	2014				2014				2014			
Quarters	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
Real economy	-0.04	-0.02	-0.03	-0.03	0.95	0.73	0.79	0.81	-3.91	-2.91	-3.36	-4.19
Excluding real economy	-0.10	-0.05	-0.05	-0.06	2.69	2.15	2.17	2.30	-3.87	-2.51	-2.48	-2.64
Real economy and other	-3.87	-2.62	-3.09	-3.72	96.36	97.12	97.03	96.90	-4.02	-2.70	-3.19	-3.84
Fiscal	-0.15	-0.09	-0.11	-0.13	3.80	3.36	3.62	3.75	-4.00	-2.75	-3.10	-3.34
Prices	-0.29	-0.17	-0.21	-0.26	7.03	6.09	6.74	6.94	-4.06	-2.80	-3.12	-3.80
Exchange rates	-0.16	-0.13	-0.15	-0.20	4.03	4.08	4.52	4.65	-4.07	-3.09	-3.39	-4.37
Interest rates and spreads	-0.99	-0.64	-0.72	-0.91	24.64	22.27	22.27	22.38	-4.01	-2.88	-3.23	-4.08
Stock markets	-0.71	-0.55	-0.67	-0.78	17.69	21.68	20.76	20.56	-4.04	-2.53	-3.23	-3.81
Economic sentiment	-0.99	-0.68	-0.84	-1.02	24.29	26.19	25.52	25.07	-4.08	-2.59	-3.29	-4.08
Loans and deposits	-0.58	-0.36	-0.39	-0.41	14.89	13.44	13.61	13.55	-3.88	-2.71	-2.84	-3.05
	FORECAST				NUMBER OF MODELS							
	-4.0	-2.7	-3.2	-3.8	12039	69021	105015	112083				



Issue 14/2

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

May 2014

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

Supervisor:	Prof. Panos Pashardes
Research Coordinator:	Dr. Nicoletta Pashourtidou
Research Officers:	Dr. Christos Papamichael Mr. Adamos Andreou
Academic Advisors:	Assoc. Prof. Elena Andreou Assoc. Prof. Andros Kourtellos

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