Issue 14/3

ECONOMIC OUTLOOK

ECONOMICS RESEARCH CENTRE

July 2014

UNIVERSITY OF CYPRUS

SUMMARY

The recession in 2014 is forecasted to moderate compared to 2013. Real GDP growth for 2014 is projected at -2.7%. During the second quarter of 2014 real GDP is estimated to contract (y-o-y) by 2.7%; in the third and fourth quarter real activity is forecasted to decline by 2.3% and 1.6%, respectively. The recession is forecasted to persist in 2015 but the contraction of real GDP is estimated to decelerate further at -0.7%. Real output is projected to fall (y-o-y) by 1.1% in the first quarter of 2015 and by 0.8% in the second and third quarter; in the final quarter of 2015 real GDP is forecasted to remain flat.

The decline in output for 2014 is estimated to be less severe than that registered in previous quarters, as the recession in Cyprus eased further during the first quarter of the year and economic conditions in the EU continued to improve. Domestic leading indicators associated with real activity and the labour market have also been picking up, adding to the less negative economic outlook. Other 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 stock markets and (iii) the slowdown of the contraction of deposits. At the same time the adverse domestic credit conditions, marked by the ongoing decline of loans and relatively high lending interest rates, are found to put a drag on activity; especially towards the end of 2014 and in 2015. The decline in the spreads of European countries in the periphery – including those of Cyprus – can be viewed as having an indirect positive effect on domestic activity. Nevertheless, recent positive developments regarding European spreads, the economic sentiment and the stock markets do not suffice to project growth for 2015, given the current domestic real economy conditions.

The forecasts are accompanied by downside risks stemming mainly from the domestic banking sector and the external environment. In particular,

- The rising level of non-performing loans in combination with delays in the reform of the relevant legal framework threatens banks' capital buffers and reinforces tight credit conditions. Delays and obstacles in the effective management of non-performing loans could undermine the fragile confidence in the banking sector with negative effects on domestic activity.
- Delays in the advancement of agreed structural reforms could damage economic confidence and create risks to fiscal targets and activity.
- New sanctions on Russia by EU, as a result of the crisis in Ukraine, as well as weaker growth in Russia could affect negatively international business activities and tourism revenues in Cyprus.
- Weaker than expected growth in the euro area could impact negatively on domestic activity.

Upside risks to the outlook include investment decisions directly or indirectly linked to the sectors of energy and tourism, a better than anticipated tourist season and stronger growth in the United Kingdom.

The projections in this bulletin indicate a milder recession for 2014 compared to the contraction of real GDP by 4.2% forecasted in the economic adjustment programme for Cyprus. For 2015, the projections given here indicate that activity will continue to decline, albeit at a slower pace than in 2014, while weak growth of 0.4% is forecasted in the adjustment programme. Although the error pertaining to the projections for 2015 presented here is relatively large, the evidence for a more protracted activity contraction is consistent with some of the attributes of this recession, such as high private and public sector indebtedness levels, adverse credit conditions and deleveraging, weighing further on domestic demand, most notably investment.

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1. Recent developments

The recession in Cyprus eased during the first quarter of 2014 as real GDP declined by 4.1% year-on-year (y-o-y). In all sectors except agriculture, the contraction of the gross value added was less severe in the first quarter of 2014 than in the final quarter of 2013. Nevertheless, real activity in the sectors of construction and financial and insurance activities continued to shrink at double-digit rates, similar to those recorded in the previous two quarters. Real estate is the only sector that is still growing, albeit at a diminishing rate. Consumption in the first quarter also continued to decline (y-o-y) but at slower rates than in 2013. The contraction of government consumption during the first quarter was twice that exhibited in private expenditure. A reduction of over 20% (y-o-y) in gross capital formation persisted during the first quarter of 2014; it was mostly driven by the decline in construction investment and inventories. The share of investment to GDP is currently down to half its pre-crisis contribution. Net exports remained positive in the first quarter of 2014 due to decreased imports and unchanged exports (y-o-y).

Throughout the first half of 2014, the Economic Sentiment Indicator (ESI) was trending upwards as confidence was strengthening in all sectors, most notably in services. ESI reached its historical average in June despite real activity remaining depressed. In the second quarter firms' activity perceptions and expectations improved considerably, but the upturn in firms' employment expectations was milder (Figure 1). The Consumer Confidence Indicator continued its gradual recovery during the second quarter (Figure 2). The current trends in economic sentiment data suggest that activity contraction is likely to decelerate further in the short run.

The unemployment rate (Eurostat) in the first quarter was down from the historical high recorded in the final quarter of 2013; the recent data for April-May indicate that unemployment has been receding slowly. After a long period of double-digit increases, the number of registered unemployed remained flat (y-o-y) in the second quarter as a result of the decline which was observed in May and June. Moreover, the growth in the number of vacancies registered in the first quarter strengthened considerably during the second quarter of 2014.

A number of monthly leading indicators registered increase in the second quarter of 2014 compared to the corresponding period in 2013; such indicators include credit card usage, registrations of motor vehicles, volume and value index of retail trade, registration of new companies, tourist arrivals, revenue from tourism and the Cyprus stock exchange index. Other indicators relating to construction and manufacturing – such as cement sales, building permits and industrial production – are still underperforming.

The stock of domestic loans continued to decline in April-May at about the same rate as in the first quarter of 2014 reflecting to some extent the ongoing deleveraging and limited credit supply, as well as subdued demand resulting partly from high indebtedness. Adverse credit conditions are also reflected in the relatively high lending rates, in spite of the small reductions observed in May. Non-performing loans (as a percentage of total credit facilities) peaked in May at 43.6% and 52.6% for banks' local operations and the cooperative sector, respectively. Nevertheless, in April-May there was a noticeable slowdown in the contraction (y-o-y) of deposits of residents and non-residents.

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

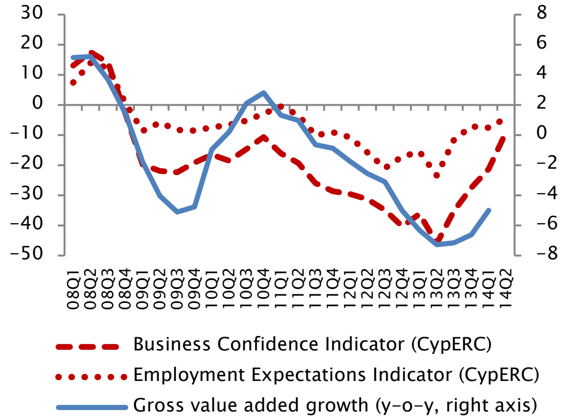
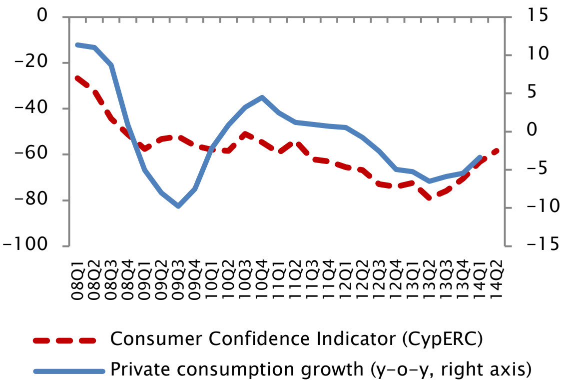


Figure 2: Consumer Confidence Indicator (CypERC) and private consumption growth



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Deflation measured by the Consumer Price Index (CPI) has been decelerating throughout the second quarter of 2014. Negative inflation persisted for a fifth consecutive quarter as CPI declined by 1.4% (y-o-y) in the second quarter, due to weak domestic activity and mild energy price inflation – combined with the strengthening of the euro against the US dollar during the same period.

2. Forecasts

Projections for GDP growth are constructed using quarterly data available up to the first quarter of 2014. Monthly indicators released by 7 July 2014 that contain information covering the first months of the second 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 second, third and 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 recession is forecasted to moderate throughout 2014. Real GDP growth for the whole year is projected at -2.7%. During the second quarter of 2014 real GDP is estimated to contract by 2.7%; in the third and fourth quarter real activity is forecasted to decline by 2.3% and 1.6%, respectively.
- The recession is forecasted to persist in 2015, albeit the contraction of real activity is estimated to decelerate, with real GDP growth projected at -0.7%. Real output is projected to fall by 1.1% in the first and by 0.8% in the second and third quarter; in the final quarter of 2015 real GDP is forecasted to remain flat.

Table 1 presents also the forecast errors associated with the estimated y-o-y growth rates in each quarter; apparently forecasts computed for 2015 are accompanied by larger errors than those for 2014.

[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 across forecasts from models that historically outperform a simple univariate model.

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

Year	2014			
FORECAST[2]	-2.7			
Quarter		2	3	4
FORECAST (y-o-y)		**-2.7**	**-2.3**	**-1.6**
Forecast error[3]		*0.6*	*1.3*	*1.9*
COMPONENTS[4]				
Real economy		**-0.02**	**-0.02**	**-0.01**
Excluding real economy		**-0.03**	**-0.04**	**-0.02**
Real economy & other aspects		**-2.63**	**-2.26**	**-1.53**
Fiscal		-0.06	-0.08	-0.04
Prices		-0.16	-0.14	-0.09
Exchange rates		-0.09	-0.10	-0.06
Interest rates and spreads		-0.64	-0.54	-0.37
Stock markets		-0.50	-0.49	-0.38
Economic sentiment		-0.82	-0.59	-0.45
Loans and deposits		-0.37	-0.32	-0.14
Year	2015			
FORECAST	-0.7			
Quarter	1	2	3	4
FORECAST (y-o-y)	**-1.1**	**-0.8**	**-0.8**	**0.0**
Forecast error[3]	*3.0*	*3.8*	*4.3*	*4.8*
COMPONENTS[4]				
Real economy	**-0.01**	**-0.01**	**0.00**	**0.00**
Excluding real economy	**-0.01**	**0.01**	**0.01**	**0.03**
Real economy & other aspects	**-1.08**	**-0.83**	**-0.77**	**-0.04**
Fiscal	0.01	0.04	0.07	0.13
Prices	-0.04	-0.03	-0.01	0.03
Exchange rates	-0.05	-0.05	-0.03	-0.01
Interest rates and spreads	-0.25	-0.22	-0.19	-0.03
Stock markets	-0.32	-0.25	-0.30	-0.11
Economic sentiment	-0.37	-0.32	-0.29	-0.12
Loans and deposits	-0.05	-0.02	-0.02	0.07

[1] Table 1 is presented in the Appendix (Table A1 and A2) 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] For the first quarter of 2014 the y-o-y growth rate of GDP is used which is obtained from published data (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 06/06/2014).

[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.

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 2% to 4%).[2] However, *real economy jointly with other* components plays a key role in determining the forecasts.

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). 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, 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 10% – 14% to the shaping of final forecasts.

The decline in output for 2014 is estimated to be less severe than that registered in the previous quarters, as the recession in Cyprus eased further during the first quarter of the year and economic conditions in the EU continued to improve. The following developments are associated with the less negative growth projections for 2014:

- The contraction of domestic real economic activity has been slowing down since the third quarter of 2013. Leading indicators relating to consumption (e.g. volume/value index of retail trade, credit card usage, and registration of motor vehicles) registered y-o-y growth in the first quarter of 2014 and continued to pick up in the first months of the second quarter.
- Domestic labour market indicators (e.g. registered unemployed, unemployment rate, job vacancies, employment) have been improving after the last quarter of 2013.
- Growth in the EU and the euro area strengthened in the first quarter of 2014; the unemployment rate in the euro area has been receding, albeit very slowly.

[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.

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

- The Economic Sentiment Indicator for Cyprus was rising throughout the first half of 2014 reflecting confidence strengthening mainly in services. Economic confidence in the EU and the euro area in the first half of 2014 continued to improve but at a rather slow pace; the Economic Sentiment Indicators for the EU and euro area have been standing slightly above the long-run average.
- In the first half of the year international stock markets continued to produce positive y-o-y returns, but lower compared to those in the last quarter of 2013. The Cyprus stock exchange (general) index registered positive y-o-y returns in the first half of the year.
- The y-o-y decline in deposits slowed down in the first quarter and decelerated even further in the first months of the second quarter; foreign deposits increased (q-o-q) during April-May.

The fiscal performance in the recent quarters, driven by policies that curb government deficit, appear to be conducive to a milder recession not only in 2014 but also in 2015.

Despite the improvements in many indicators during the first half of 2014, domestic labour market conditions remain unfavourable as high unemployment persists and investment continues to shrink at fast rates hampering recovery in 2015. At the same time the adverse domestic credit conditions, marked by the ongoing decline of loans and relatively high lending interest rates, are found to put a drag on activity, especially at the end of 2014 and in 2015.

The decline in the spreads of European countries in the periphery, including those of Cyprus, can be viewed as having an indirect positive effect on domestic activity. Nevertheless, recent positive developments regarding European spreads, the economic sentiment and the stock markets do not suffice to project growth for 2015, given the current domestic real economy conditions. Despite the marginal reductions in the domestic lending interest rates, their existing levels that reflect lack of liquidity and other institutional failures appear to weigh heavily on activity in 2015, given the present state of the local real economy.

The downside risks associated with the forecasts in the previous issue persist and mostly relate to the domestic banking sector and the external environment. In particular, downside risks to the economic outlook include the following:

- A prolonged period of tight credit conditions could have both short- and long-term negative effects on investment, employment and growth.
- The rising level of non-performing loans in combination with delays in the reform of the relevant legal framework (foreclosure law) threatens banks' capital buffers and reinforces tight credit conditions. Moreover, delays and obstacles in the effective management of non-performing loans could undermine fragile confidence in the banking sector with negative effects on domestic activity.
- Delays in the advancement of agreed structural reforms could damage economic confidence and create risks to fiscal targets and activity.
- New sanctions on Russia by EU, as a result of the crisis in Ukraine, as well as weaker growth in Russia could affect negatively international business activities and tourism revenues in Cyprus (e.g. IMF revised Russia's growth projections for both 2014 and 2015 downwards [3]).
- Weaker than expected growth in the euro area could impact negatively on domestic activity. The European Central Bank revised the growth projection for 2014 downwards, while the forecast for 2015 was revised upwards. Nevertheless, it is stated that the risks to the outlook for the euro area are tilted to the downside [1].

Upside risks to the outlook include investment decisions directly or indirectly linked to the sectors of energy and tourism, a better than anticipated tourist season and stronger growth in the United Kingdom (e.g. IMF revised United Kingdom's growth projections for both 2014 and 2015 upwards [3]).

3. Concluding remarks

Quarterly data available up to the first quarter of 2014 and monthly indicators released early in July 2014 are employed in dynamic econometric models to construct forecasts for GDP growth. The forecast for the annual growth rate of real GDP in 2014 presented in this bulletin is less negative compared to the forecast in the previous issue as a result of the less negative y-o-y growth rates projected for the third and fourth quarter of the year. The forecast for 2014 is revised from -3.4% to -2.7%. The revision is driven by the moderation of the recession in Cyprus for a third consecutive quarter and the stronger recovery in the euro area in the first quarter of 2014. Domestic leading indicators associated with real activity and the labour market continued to improve, 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 stock markets and (iii) the slowdown of the contraction of deposits. Nevertheless, the econometric analysis shows that recession is likely to persist in 2015 as real GDP growth is projected at -0.7%. The downside risks to the outlook, especially for 2014, still dominate as the level of non-performing loans is on the rise and, therefore, credit remains tight amidst conditions of elevated unemployment.

The projections in this bulletin indicate a milder recession for 2014 compared to the contraction of real GDP by 4.2% forecasted in the economic adjustment programme for Cyprus ([2], [4]). For 2015 the projections given here suggest that activity will continue to decline, albeit at a slower rate than in 2014; while weak growth at 0.4% is forecasted in the economic adjustment programme ([2], [4]). Although the error surrounding the projections for 2015 presented here is relatively large, the evidence for a more protracted activity contraction is consistent with some of the attributes of this recession such as high private and public sector indebtedness levels, adverse credit conditions and deleveraging weighing further on domestic demand, most notably investment. Therefore, the prompt implementation of structural and financial sector reforms could improve the outlook and maintain the satisfactory levels of economic confidence which were reached recently.

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APPENDIX

Table A1: GDP growth forecasts (components of forecasts, weights and forecast by component), 2014

	CONTRIBUTION BY COMPONENT			WEIGHT			FORECAST BY COMPONENT		
	2014			2014			2014		
Quarters	2	3	4	2	3	4	2	3	4
COMPONENTS									
Real economy	−0.02	−0.02	−0.01	0.70	0.64	0.63	−2.79	−2.63	−1.85
Excluding real economy	−0.03	−0.04	−0.02	0.95	1.71	1.75	−2.86	−2.19	−1.37
Real economy & other aspects	−2.63	−2.26	−1.53	98.35	97.65	97.62	−2.68	−2.32	−1.57
Fiscal	−0.06	−0.08	−0.04	2.39	3.73	3.51	−2.52	−2.16	−1.02
Prices	−0.16	−0.14	−0.09	5.74	6.04	5.38	−2.72	−2.34	−1.64
Exchange rates	−0.09	−0.10	−0.06	3.24	4.11	3.50	−2.74	−2.45	−1.79
Interest rates & spreads	−0.64	−0.54	−0.37	23.47	22.80	21.71	−2.71	−2.38	−1.71
Stock markets	−0.50	−0.49	−0.38	19.24	21.03	23.86	−2.62	−2.32	−1.60
Economic sentiment	−0.82	−0.59	−0.45	30.43	26.07	29.11	−2.69	−2.26	−1.54
Loans & deposits	−0.37	−0.32	−0.14	13.83	13.88	10.55	−2.65	−2.30	−1.36
	FORECAST			NUMBER OF MODELS					
	−2.7	−2.3	−1.6	9688	19863	16461			

Table A2: GDP growth forecasts (components of forecasts, weights and forecast by component), 2015

	CONTRIBUTION BY COMPONENT				WEIGHT				FORECAST BY COMPONENT			
Year	2015				2015				2015			
Quarters	1	2	3	4	1	2	3	4	1	2	3	4
COMPONENTS												
Real economy	−0.01	−0.01	0.00	0.00	0.63	0.67	0.57	0.48	−1.31	−1.00	−0.82	−0.46
Excluding real economy	−0.01	0.01	0.01	0.03	2.19	2.35	2.64	3.26	−0.44	0.27	0.42	0.92
Real economy & other aspects	−1.08	−0.83	−0.77	−0.04	97.18	96.98	96.79	96.27	−1.11	−0.86	−0.79	−0.04
Fiscal	0.01	0.04	0.07	0.13	3.76	3.82	4.10	4.61	0.31	1.10	1.83	2.77
Prices	−0.04	−0.03	−0.01	0.03	6.02	6.38	6.53	7.13	−0.71	−0.42	−0.17	0.45
Exchange rates	−0.05	−0.05	−0.03	−0.01	3.37	3.91	3.74	3.43	−1.57	−1.21	−0.72	−0.34
Interest rates & spreads	−0.25	−0.22	−0.19	−0.03	21.35	21.75	20.49	17.43	−1.19	−1.00	−0.94	−0.19
Stock markets	−0.32	−0.25	−0.30	−0.11	26.01	23.34	27.38	29.37	−1.25	−1.06	−1.10	−0.37
Economic sentiment	−0.37	−0.32	−0.29	−0.12	26.46	26.21	23.00	20.56	−1.39	−1.21	−1.28	−0.57
Loans & deposits	−0.05	−0.02	−0.02	0.07	10.21	11.56	11.54	13.73	−0.52	−0.15	−0.15	0.53
	FORECAST				NUMBER OF MODELS							
	−1.1	−0.8	−0.8	0.0	15419	17736	14155	9671				

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