Issue 15/3

# ECONOMIC OUTLOOK

## ECONOMICS RESEARCH CENTRE

UNIVERSITY OF CYPRUS

## August 2015


SUMMARY

Economic activity is forecasted to pick up further in the following quarters of 2015 and in 2016. Real GDP growth for 2015 is projected at 1.1%. Real output is estimated to expand (y-o-y) by 0.5% in the second quarter of 2015 and by about 1.8% in the second half of the year. The projected growth rates for the second half of 2015 reflect the low levels of GDP reached during the corresponding period in 2014. The economic recovery is projected to be rather slow as real GDP growth in 2016 is forecasted also at 1.1%.

The main drivers of the projected recovery are given below.

- The turnaround in domestic real economic activity and employment in the first quarter of 2015 which was followed by further improvements in a number of domestic leading indicators in the second quarter.
- The expansion of output in the EU and the euro area in the first quarter of 2015 creates a less adverse external environment for Cyprus.
- The lower international oil prices, in spite of the depreciation of the euro against the US dollar, as well as low inflation in the EU which leads to higher real incomes and stronger external demand.
- The faster weakening of the euro against the British pound in the first half of 2015 is expected to boost domestic activity in the following quarters through tourism services. The slowdown of the Russian rouble depreciation against the euro in the second quarter has created less unfavourable conditions for foreign demand in Cyprus.
- The recent reductions in domestic lending interest rates amid conditions of weak demand and elevated unemployment are found to facilitate economic recovery. Furthermore, the return of domestic economic confidence to pre-crisis levels is estimated to boost growth in subsequent quarters.

Downside risks to the growth projections are associated with the following:

- The high levels of non-performing loans pose major risks to the stability of the banking system and to the outlook for the economy. Ineffective implementation of the new insolvency and foreclosure legal framework and bottlenecks in the introduction of legislation for the sale of loans could delay the resumption of healthy credit conditions and economic growth.
- Lack of progress with structural reforms agreed in the economic adjustment programme (e.g. public administration, privatisations, health system).
- The recent economic developments in Greece which have worsened the outlook for the Greek economy could have a direct negative impact on the domestic economy, but could also cause adverse effects on Cyprus's sovereign bond yields through heightened market uncertainty.
- The recession in the Russian economy and rouble depreciation against the euro are likely to affect the outlook especially for 2015.

Upside risks to the outlook relate to stronger growth in the euro area, solid growth in the UK combined with the weakening of the euro against the British pound and a better than expected economic performance in Russia. Moreover, the negative impact of developments in Greece on the Cypriot economy could be short-lived as the connection between the financial systems of the two countries was limited in 2013. Progress with the implementation of the adjustment programme in Cyprus (i) provides access to the ECB's monetary stimulus programme (expanded asset purchase programme) safeguarding the liquidity of the domestic banking system, and (ii) decouples markets' sovereign risk assessments for Cyprus from those for Greece.

CPI inflation is projected at -1.7% and 0.7% for 2015 and 2016 respectively. The negative inflation projection for 2015 is driven by the lower international oil prices combined with sluggish domestic demand. Low inflation is expected in 2016 as domestic demand and oil prices are anticipated to rise.


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## 1. Recent developments

After 3½ years of declining economic activity, real GDP in Cyprus increased by 0.2% year-on-year (y-o-y) in the first quarter of 2015. The increase of the gross value added in trade, transport, accommodation and food services as well as in professional and administrative services contributed the most to the pickup of activity. On the demand side, growth in the first quarter was backed by the expansion of private consumption and fixed investment, while net exports contributed marginally.

The improvements registered in many domestic leading indicators in the first quarter continued during the second quarter (e.g. volume index of retail trade, registrations of motor vehicles, cement sales, registrations of new companies, credit card usage, tourist arrivals from the UK). Furthermore, the good fiscal performance continued as primary surplus was recorded in April-May. The economic sentiment strengthened further in the second quarter reflecting improvements in consumer and industrial confidence as well as firming confidence in services. Nevertheless, the recent developments in Greece adversely affected the economic sentiment in Cyprus in July.

Lending interest rates declined further in April-May and loans to non-financial corporations continued to register a small positive growth rate in the second quarter. The challenges for the banking system, however, are still present as the level of non-performing loans (as a percentage of total loans and advances) remains extremely high by international comparisons.

The elevated unemployment rate persists (about 16%), although the reduction in the number of registered unemployed accelerated further in the second quarter. The general price level decreased by more in the second quarter compared to the first as a result of muted demand and falling international oil prices, despite the weakening of the euro against the US dollar.

## 2. Forecasts

Projections for GDP growth and CPI inflation are constructed using quarterly data available up to the first quarter of 2015. Monthly indicators released by 20 July 2015 that contain information covering at most the three months in the second quarter 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 the estimations.

The forecasts for the (y-o-y) growth rate of real GDP for the second, third and final quarter of 2015 as well as for all the quarters of 2016 are shown in Table 1; projections for the whole of 2015 and 2016 are also provided. [1]

- Based on the historical relationships between growth and numerous macroeconomic indicators, real output is forecasted to grow in 2015 at 1.1% compared to 2014. Real GDP is projected to expand faster in the second half of 2015; these estimates reflect also base effects as the *level* of real GDP bottomed out in the second half of 2014.
- The recovery is not expected to gain significant momentum until after the first half 2016 when the y-o-y growth rate is estimated to exceed 1%. Real GDP growth for the whole of 2016 is projected at 1.1%.
- The y-o-y growth rates given in Table 1 imply quarter-on-quarter (q-o-q) percentage changes which average about 0.2% for the last three quarters of 2015. The q-o-q growth for the first and second half of 2016 is 0.1% and 0.7% respectively.

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

The forecasts in all quarters are mainly formed by models that include (one at a time) interest rates, spreads, economic

[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.

[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 series.

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.

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

| YEAR | 2015 | | | |
|---|---|---|---|---|
| FORECAST[2] | 1.1 | | | |
| Quarter | | 2 | 3 | 4 |
| FORECAST (y-o-y) | | 0.5 | 1.4 | 2.1 |
| Forecast error[3] | | 0.8 | 1.5 | 2.3 |
| *COMPONENTS*[4] | | | | |
| *Real economy* | | 0.00 | 0.01 | 0.01 |
| *Excluding real economy* | | 0.01 | 0.02 | 0.03 |
| *Real economy & other aspects* | | 0.53 | 1.42 | 2.02 |
| Fiscal | | 0.01 | 0.02 | 0.03 |
| Prices | | 0.04 | 0.10 | 0.14 |
| Exchange rates | | 0.02 | 0.06 | 0.07 |
| Interest rates, spreads | | 0.16 | 0.50 | 0.81 |
| Stock markets | | 0.10 | 0.25 | 0.36 |
| Econ. sentiment | | 0.09 | 0.29 | 0.34 |
| Loans and deposits | | 0.10 | 0.20 | 0.28 |
| YEAR | 2016 | | | |
| FORECAST | 1.1 | | | |
| Quarter | 1 | 2 | 3 | 4 |
| FORECAST (y-o-y) | 0.8 | 0.7 | 1.1 | 1.6 |
| Forecast error[3] | 3.1 | 3.7 | 4.3 | 4.6 |
| *COMPONENTS*[4] | | | | |
| *Real economy* | 0.01 | 0.01 | 0.01 | 0.01 |
| *Excluding real economy* | 0.02 | 0.02 | 0.03 | 0.03 |
| *Real economy & other aspects* | 0.82 | 0.66 | 1.12 | 1.52 |
| Fiscal | 0.01 | 0.01 | 0.02 | 0.03 |
| Prices | 0.07 | 0.05 | 0.09 | 0.13 |
| Exchange rates | 0.04 | 0.03 | 0.04 | 0.05 |
| Interest rates, spreads | 0.32 | 0.27 | 0.44 | 0.53 |
| Stock markets | 0.18 | 0.09 | 0.20 | 0.29 |
| Econ. sentiment | 0.14 | 0.11 | 0.19 | 0.25 |
| Loans, deposits | 0.05 | 0.09 | 0.14 | 0.25 |

[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] For the first quarter of 2015 the y-o-y growth rate of GDP obtained from published data is used (Quarterly National Accounts, Seasonally Adjusted Data, Statistical Service, 09/06/2015).

[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 main drivers of the recovery of the Cypriot economy projected for the following quarters are discussed below.

- The turnaround in domestic real economic activity and employment in the first quarter of 2015 was followed by further improvements in a number of activity-related leading indicators (e.g. volume index of retail trade, registrations of motor vehicles, cement sales, registrations of new companies, credit card usage, tourist arrivals from the UK) during the second quarter. Moreover, the number of registered unemployed continued to fall in the second quarter by a faster pace compared to previous quarters.
- Real GDP in the EU and the euro area expanded in the first quarter of 2015 creating a less adverse external environment for Cyprus, although no significant strengthening of growth was recorded. The UK economy registered solid growth in first quarter but the rate was somewhat slower compared to the last quarter of 2014.
- In spite of the depreciation of the euro against the US dollar, the lower international oil prices and the easing of international non-energy commodity prices are found support the pickup of real activity in the following quarters. Low inflation in the EU is also conducive to the improved outlook, possibly by firming external demand through higher real incomes.
- The faster weakening of the euro against the British pound in the first half of 2015 is expected to boost domestic activity in the following quarters through exports, particularly tourism services. The slowdown of the Russian rouble depreciation against the euro in the second quarter has created less unfavourable conditions for foreign demand in Cyprus.
- The recent reductions in domestic lending interest rates amid conditions of weak demand and elevated unemployment are found to facilitate economic recovery. Furthermore, the return of domestic economic confidence to pre-crisis levels is estimated to drive growth in subsequent quarters.

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

The high levels of corporate and household indebtedness and the process of deleveraging as well as the stricter lending practices recently adopted by banks have resulted in a prolonged period of contraction in lending that puts a drag on growth in the next quarters. The protracted contraction of deposits which exerts pressures on banks' liquidity is also found to weaken the outlook.

In spite of the positive growth in the Greek economy in the first quarter, the outlook has considerably worsened possibly straining the Cypriot economy. The economic uncertainty in Greece has been reflected by the declining Athens stock exchange index with negative effects on the Cyprus stock market, the sliding Greek confidence indicators and the rising long-term interest rate on Greek government bonds. The performance of the abovementioned indicators adversely affects the recovery process in Cyprus due to the links between the two countries. The positive effects of the good performance of the corresponding European indicators (i.e. improved sentiment, stock market returns, low interest rates and spreads) on the Cypriot economy is, therefore, dampened.

Another external factor that weighs on the outlook is the economic downturn in Russia which has taken its toll on the arrivals of Russian tourists in Cyprus with possible negative effects on tourism revenue as the per capita spending of Russian tourists in Cyprus has been relatively high. However, the slowdown of the rouble depreciation against the euro in the second quarter, and the better than expected performance of the Russian economy in 2014 may mitigate the negative impact on the Cypriot economy. Relatedly, the latest IMF growth projections for Russia in 2015 and 2016 were less pessimistic [4].

There are both downside and upside risks to the outlook. Downside risks to the growth projections are discussed below.

- The high levels of non-performing loans pose major risks to the stability of the banking system and to the outlook for the economy. Ineffective implementation of the new insolvency and foreclosure legal framework and bottlenecks in the introduction of legislation for the sale of loans could delay the resumption of healthy credit conditions and economic growth.
- Lack of progress with structural reforms agreed in the economic adjustment programme (e.g. public administration, privatisations, health system) may create risks to public finances, Cyprus's market borrowing costs and, therefore, to activity.
- The recent economic developments in Greece (e.g. capital controls, discussions for a new bailout programme) which have worsen the outlook for the Greek economy could have a direct negative impact on the domestic economy but could also cause adverse effects on Cyprus's sovereign bond yields through heightened market uncertainty.
- The recession in the Russian economy and rouble depreciation against the euro are likely to affect the outlook especially in 2015.

Upside risks to the outlook relate to both external and domestic factors. Growth in the euro area in 2015 and 2016 is expected to strengthen compared to 2014 (according to the recent ECB and IMF projections [1], [4]), leading to stronger external demand for Cyprus's goods and services. Solid growth in the UK combined with the weakening of the euro against the British pound could also benefit exports, most notably tourism. A better than expected outcome for the Russian economy could benefit the outlook for the Cypriot economy; the IMF revised Russia's growth projections for 2015 and 2016 upwards.

The negative impact of the developments in Greece on the Cypriot economy could be short-lived as the connection between the financial systems of two countries was limited in 2013. Progress with the implementation of the adjustment programme in Cyprus (i) provides access to the ECB's monetary stimulus programme (asset purchase programme) safeguarding the liquidity of the domestic banking system, and (ii) decouples markets' sovereign risk assessments for Cyprus from those for Greece.

On the domestic front, 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 -1.7% and 0.7% for 2015 and 2016 respectively.[3] The negative inflation projection for 2015 is driven by the lower international oil prices combined with sluggish domestic demand, resulting in larger price decreases in the first half of 2015 compared to the second half of 2014. Low inflation is expected in 2016 as domestic demand and oil prices are anticipated to rise. Upside risks to the forecasts relate to increases in international commodity prices and further weakening of the euro. Downside risks to the projections are associated with weaker than expected demand.

[3] CPI inflation forecasts are constructed using a methodology similar to that for GDP growth forecasts (see footnote 1).

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## 3. Concluding remarks

Quarterly data available up to the first quarter of 2015 and monthly indicators for the second quarter released until 20 July 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 -0.9% in the April issue to 1.1%. The significant upward revision to the forecast for 2015 resulted from the turnaround of real GDP growth in the first quarter and from further improvements registered in a number of domestic leading indicators during the second quarter.

The forecast for CPI inflation for 2015 is revised from -0.9% in the April issue to -1.7% mainly as a result of declining international oil prices combined with weak domestic demand that led to a larger drop in the general price level in the first half of 2015 compared to previous quarters.

The forecasts for 2015 and 2016 given here suggest that activity will continue to improve. Stronger growth in the second half of 2015 reflects also base effects as the *level* of real GDP bottomed out in the second half of 2014. The recovery is not expected to gain significant momentum until after the first half 2016. The European Commission and the IMF project weaker growth (0.2%) for 2015 and slightly stronger recovery (1.4%) for 2016 than the estimates provided here [2], [3]. The forecasts given in this bulletin are accompanied by upside and downside risks related to both external and domestic factors.

### REFERENCES

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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 | 2015 | | | 2015 | | | 2015 | | |
| Quarter | 2 | 3 | 4 | 2 | 3 | 4 | 2 | 3 | 4 |
| COMPONENTS | | | | | | | | | |
| Real economy | 0.00 | 0.01 | 0.01 | 0.62 | 0.56 | 0.46 | 0.60 | 1.54 | 2.08 |
| Excluding real economy | 0.01 | 0.02 | 0.03 | 0.93 | 1.11 | 1.21 | 0.62 | 1.84 | 2.39 |
| Real economy & other aspects | 0.53 | 1.42 | 2.02 | 98.45 | 98.33 | 98.33 | 0.54 | 1.44 | 2.05 |
| Fiscal | 0.01 | 0.02 | 0.03 | 1.62 | 1.52 | 1.22 | 0.71 | 1.42 | 2.11 |
| Prices | 0.04 | 0.10 | 0.14 | 6.63 | 7.00 | 6.97 | 0.66 | 1.42 | 2.06 |
| Exchange rates | 0.02 | 0.06 | 0.07 | 3.83 | 3.51 | 2.92 | 0.62 | 1.61 | 2.31 |
| Interest rates, spreads | 0.16 | 0.50 | 0.81 | 28.74 | 31.65 | 37.32 | 0.55 | 1.59 | 2.17 |
| Stock markets | 0.10 | 0.25 | 0.36 | 17.47 | 17.60 | 16.35 | 0.57 | 1.42 | 2.19 |
| Economic sentiment | 0.09 | 0.29 | 0.34 | 21.29 | 21.14 | 17.06 | 0.43 | 1.36 | 1.99 |
| Loans, deposits | 0.10 | 0.20 | 0.28 | 18.87 | 15.90 | 16.48 | 0.52 | 1.26 | 1.67 |
| | FORECAST | | | NUMBER OF MODELS | | | | | |
| | 0.5 | 1.4 | 2.1 | 16642 | | | | | |

| | CONTRIBUTION BY COMPONENT | | | | WEIGHT | | | | FORECAST BY COMPONENT | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | 2016 | | | | 2016 | | | | 2016 | | | |
| Quarter | 1 | 2 | 3 | 4 | 1 | 2 | 3 | 4 | 1 | 2 | 3 | 4 |
| COMPONENTS | | | | | | | | | | | | |
| Real economy | 0.01 | 0.01 | 0.01 | 0.01 | 0.49 | 0.48 | 0.44 | 0.43 | 1.18 | 1.09 | 1.88 | 2.56 |
| Excluding real economy | 0.02 | 0.02 | 0.03 | 0.03 | 1.37 | 1.50 | 1.82 | 2.01 | 1.24 | 1.13 | 1.43 | 1.60 |
| Real economy & other aspects | 0.82 | 0.66 | 1.12 | 1.52 | 98.14 | 98.02 | 97.74 | 97.57 | 0.83 | 0.67 | 1.14 | 1.56 |
| Fiscal | 0.01 | 0.01 | 0.02 | 0.03 | 1.32 | 1.38 | 1.28 | 1.34 | 0.87 | 0.83 | 1.52 | 2.30 |
| Prices | 0.07 | 0.05 | 0.09 | 0.13 | 6.85 | 5.99 | 5.47 | 5.69 | 1.00 | 0.91 | 1.57 | 2.22 |
| Exchange rates | 0.04 | 0.03 | 0.04 | 0.05 | 2.87 | 2.97 | 2.73 | 2.71 | 1.47 | 0.99 | 1.61 | 1.95 |
| Interest rates, spreads | 0.32 | 0.27 | 0.44 | 0.53 | 31.74 | 36.54 | 39.22 | 34.64 | 1.02 | 0.75 | 1.11 | 1.52 |
| Stock markets | 0.18 | 0.09 | 0.20 | 0.29 | 17.76 | 17.06 | 14.09 | 13.28 | 1.03 | 0.55 | 1.44 | 2.21 |
| Economic sentiment | 0.14 | 0.11 | 0.19 | 0.25 | 16.82 | 14.46 | 12.91 | 11.69 | 0.82 | 0.75 | 1.45 | 2.11 |
| Loans, deposits | 0.05 | 0.09 | 0.14 | 0.25 | 20.78 | 19.63 | 22.03 | 28.21 | 0.25 | 0.46 | 0.63 | 0.88 |
| | FORECAST | | | | NUMBER OF MODELS | | | | | | | |
| | 0.8 | 0.7 | 1.1 | 1.6 | 16642 | | | | | | | |

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## ECONOMICS RESEARCH CENTRE

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